STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

Illinois-American Water Company	**:**	
	:	
Proposed general increase in water and sewer rates. (Tariffs filed May 29, 2009)	**:**	**09-0319**
	:	
	:	

<u>PROPOSED ORDER</u>

DATED: February 22, 2010

TABLE OF CONTENTS

STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

Illinois-American Water Company	:	
	:	
Proposed general increase in water and sewer rates. (Tariffs filed May 29, 2009)	:	**09-0319**
	:	
	:	

ORDER

By the Commission:

I. PROCEDURAL BACKGROUND

On May 29, 2009, Illinois-American Water Company ("IAWC," "Illinois-American" or the "Company") filed with the Illinois Commerce Commission ("Commission") its new and/or revised tariff sheets for water and sewer service identified as: Ill. C. C. No. 4 (Water) 6th Revised Sheet No. 36, 6th Revised Sheet No. 37, 5th Revised Sheet No. 38, 4th Revised Sheet No. 40, 5th Revised Sheet No. 46, 5th Revised Sheet No. 47, 6th Revised Sheet No. 49, 3rd Revised Sheet No. 59, 3rd Revised Sheet No. 60, 3rd Revised Sheet No. 64, 3rd Revised Sheet No. 65, 3rd Revised Sheet No. 66, 3rd Revised Sheet No. 77, Ill. C. C. No. 5 (Water) 34th Revised Sheet No. 1, 22nd Revised Sheet No. 1.1, 5th Revised Sheet No. 1.2, 31st Revised Sheet No. 2, 26th Revised Sheet No. 2.1, 26th Revised Sheet No. 2.3, 16th Revised Sheet No. 2.7, 7th Revised Sheet No. 2.10, 7th Revised Sheet No. 2.11, 35th Revised Sheet No. 8, 11th Revised Sheet No. 8.1, 11th Revised Sheet No. 8.2, 9th Revised Sheet No. 8.3, 27th Revised Sheet No. 10, 18th Revised Sheet No. 10.2, 28th Revised Sheet No. 11, 31st Revised Sheet No. 13, 20th Revised Sheet No. 14, 17th Revised Sheet No. 15.1, 24th Revised Sheet No. 16, 11th Revised Sheet No. 16.2, 29th Revised Sheet No. 18, 26th Revised Sheet No. 19, 19th Revised Sheet No. 19.2, 13th Revised Sheet No. 21, 8th Revised Sheet No. 21.1, Ill. C. C. No. 5 (Sewer) 10th Revised Sheet No. 37, Ill. C. C. No. 22 (Water) 15th Revised Sheet No. 1, 6th Revised Sheet No. 1.6, 13th Revised Sheet No. 2, 5th Revised Sheet No. 2.1, 15th Revised Sheet No. 3, 5th Revised Sheet No. 3.1, 21st Revised Sheet No. 4, 6th Revised Sheet No. 5, 12th Revised Sheet No. 6, 13th Revised Sheet No. 7, 9th Revised Sheet No. 13, 7th Revised Sheet No. 16.2, 4th Revised Sheet No. 17.2 and 3rd Revised Sheet No. 17.3, hereinafter referred to as "Proposed Tariffs," in which it proposes a general increase in water and sewer rates, to be effective July 13, 2009.

On July 8, 2009, the Commission entered a Suspension Order suspending the Proposed Tariffs to and including October 25, 2009 in accordance with Section 9-201(b) of the Public Utilities Act ("Act"), 220 ILCS 5/1-101 et seq. On October 7, 2009, the Commission entered a Resuspension Order renewing the suspension of the Proposed Tariffs to and including April 25, 2010.

Prior to its rate case filing, on May 29, 2009, IAWC filed a request for a waiver before initiating Docket No. 09-0073. IAWC's request concerned Section 285.7010(a) of 83 Ill. Adm. Code 285, "Standard Information Requirements for Public Utilities and Telecommunications Carriers in Filing for an Increase in Rates" ("Part 285"). Section 285.7010(a) specifies that the statement of a certified public accountant in forecasting a future test year "shall . . . comply with the Guide for Prospective Financial Information as of April 1, 1999 by the American Institute of Certified Public Accountants . . . and no later amendment or edition is included in this incorporation." On March 1, 2008, the American Institute of Certified Public Accountants issued a revised Guide for Prospective Financial Information. IAWC thus requested a waiver of this requirement in order to utilize the latest version of the guide. On March 25, 2009, the Commission granted IAWC's waiver request.

Notice of the filing of the proposed rate increases was posted in each of IAWC's district business offices and was published twice in newspapers of general circulation within each district, in accordance with the requirements of Section 9-201(a) of the Act, and the provisions of 83 Ill. Adm. Code 255, "Notice Requirements for Change in Rates for Cooling, Electric, Gas, Heating, Telecommunications, Sewer or Water Services." In addition, IAWC sent notice of the filing to its customers in a bill insert.

On July 1, 2009, IAWC was notified of certain deficiencies in its filing in accordance with Part 285. The deficiency letter required IAWC to submit various missing information and provide explanations of certain portions of its rate filing. IAWC provided information in response to the deficiency letter on July 29, 2009.

Petitions seeking leave to intervene were filed by the People of the State of Illinois through the Attorney General ("AG"), Citizens Utility Board ("CUB"), Melody Fliss, Harold C. Menger, Rosemary Katona, Eileen and Tim Nelson, City of Champaign ("Champaign"), Village of Prairie Grove, Village of Mount Prospect ("Mount Prospect"), Village of Homer Glen ("Homer Glen"), City of Des Plaines ("Des Plaines"), Village of Tinley Park, City of Peoria, City of Pekin, Village of Bolingbrook ("Bolingbrook"). The University of Illinois and United States Steel Company also intervened as members of the Illinois Industrial Water Consumers ("IIWC"). Entries of appearance were filed by the Village of Woodridge and the Village of Lemont, the City of Elmhurst, the City of Urbana ("Urbana"), and the Villages of St. Joseph, Savoy and Sidney. Homer Glen, Champaign, Urbana, and the Villages of St. Joseph, Savoy and Sidney are sometimes collectively referred to as "Municipalities," or "Homer Glen et al."

On October 1, 2009, a public forum was held at the Parkland Community College in the Champaign, Illinois for the purpose of receiving public comment concerning the general increase in rates proposed by IAWC. On October 8, 2009, a public forum was held in the Mt. Prospect City Council Chambers. On October 19, 2009, a public forum was held at the Homer Jr. High School. On November 4, 2009 a public forum was held at the Wheaton Community Center and on November 9, 2009, a public form was held at the Alton Square Mall. The public forums were held in conformance with Section 8-306(n) of the Act. A transcript of each public forum was made.

Pursuant to due notice, a status hearing was held in this matter before a duly authorized Administrative Law Judge of the Commission at its offices in Springfield, Illinois on August 5, 2009. Thereafter, evidentiary hearings were held on December 8, 9, and 10, 2009. Those entering appearances at the hearings included counsel on behalf of IAWC, the AG, CUB, Bolingbrook, IIWC, Homer Glen, Champaign, Des Plaines, Urbana, the Villages of St. Joseph, Savoy and Sidney, and the Commission Staff ("Staff"). The record has been marked “Heard and Taken.”

At the evidentiary hearings, witnesses testifying for IIAW included Karla Teasley, IAWC’s President; Edward Grubb, the Assistant Treasurer and Director of Rates and Regulations for IAWC; Scott Rungren, a Financial Analyst III employed by American Water Works Service Company (“Service Company”); Rich Kerckhove, a Senior Financial Analyst; Bernard Uffelman, President of Uffelman Advisory Services, LLC; Paul Herbert of Gannett Fleming, Inc.; and Pauline Ahern, a Principal of AUS Consultants. They also included Cheryl Norton, Vice President of Operations for IAWC; Jeffrey Kaiser, who is employed by the Services Company and serves as the Director of Engineering for IAWC; Tyler Bernsen, a Financial Analyst with the Services Company; Mark Young of Deloitte & Touche LLP; John Young, President of the Services Company; J. Rowe McKinley, a Principal Consultant under a contract with Black and Veatch Corporation (“Black & Veatch”); and James Kalinovich, the Treasurer of American Water Works Company, Inc. and American Water Capital Corp. (“AWCC”).

Witnesses testifying on behalf of Staff include Daniel Kahle and Larry Wilcox, Accountants in the Accounting Department of the Financial Analysis Division of the Commission’s Bureau of Public Utilities; Sheena Kight-Garlisch and Michael McNally, Senior Financial Analysts in the Finance Department of the Financial Analysis Division; and Philip Rukosuev and Christopher L. Boggs, Rate Analysts, and Peter Lazare, Senior Rate Analyst in the Rates Department of the Financial Analysis Division.

Testifying for IIWC were Michael Gorman and Brian Collins from the consulting firm of Brubaker & Associates, Inc., and Gary Goosens, Utilities Engineer, U.S. Steel Granite City Works. Ralph C. Smith, a certified public accountant and a senior regulatory utility consultant with the firm Larkin & Associates, PLLC testified on behalf of the AG and the “Joint Municipalities” listed as Des Plaines, Bolingbrook, Homer Glen, Lemont, Mount Prospect, Prairie Grove and Woodridge, along with three villages who did not intervene. Scott Rubin, an independent consultant and attorney specializing in public utility matters, Robert Boros, a Design Engineer, and Avis Gibons, an educator and consultant, testified on behalf of the AG. Christopher Thomas, CUB’s Director of Policy, testified on behalf of CUB. Jon Duddles, Assistant Director of Public Works and Engineering and Jason Bajor, City Manager, testified for Des Plaines. Jim Daley, Mayor, Mary Niemiec, a Village trustee, Michael Schofield, Fire Chief for the Homer Township Fire Protection District and Aaron Fundich, Executive Vice President of

Robinson Engineering, Ltd. Testified on behalf of Homer Glen. Irvana Wilks, Mayor, testified for Mount Prospect.

IAWC, Staff, the AG, CUB, IIWC and Homer Glen et al. each filed an Initial Brief and Reply Brief. Bolingbrook filed an Initial Brief. A proposed Order was served on the parties.

II. NATURE OF IAWC'S OPERATIONS

IAWC, a wholly owned subsidiary of American Water, provides residential, commercial, industrial, and sale-for-resale water service, as well as fire protection service, to numerous communities in various rate areas in Illinois. Zone 1, with Champaign, includes the Southern (Alton, Cairo and Interurban including East St. Louis), Pontiac, Streator, Peoria, South Beloit, Sterling and Champaign districts. The other rate areas are Lincoln, Pekin and Chicago Metro Water. IAWC also provides public utility wastewater service in the Chicago Metro Sewer district. In all, IAWC serves over 300,000 customers in Illinois.

III. TEST YEAR AND PROPOSED REVENUE INCREASES

IAWC proposes to use the 12 months ending December 31, 2010 as the test year in this proceeding. No party objects to the use of this test year. The Commission concludes that the future test year IAWC proposes is appropriate for purposes of this proceeding.

IAWC's Proposed Tariffs purportedly reflect an increase of approximately $59 million in additional water and sewer revenues. The proposed percentage revenue increases for each Rate Area of the Company are as follows:

Zone 1 (Southern/Pontiac/Streator/Peoria/South Beloit/Sterling/Champaign)	30.08%
Lincoln	35.59%
Pekin	30.90%
Chicago-Metro Water	25.54%
Chicago-Metro Sewer	24.29%

IAWC determined these revenues using a 12.25% cost of equity and a 9.43% rate of return on rate base. IAWC's last increase in its base rates for the districts occurred in Docket No. 07-0507. The Commission entered the Order in Docket No. 07-0507 on July 30, 2008.

IV. RATE BASE

The rate base represents the net level of investment that a utility company has dedicated to public service on which it is entitled to earn a return. The rate base consists principally of book investment in utility plant and working capital, less deductions to reflect other sources of funds, such as deferred taxes. Schedules showing IAWC's rate base at present and recommended rates for the future test year were presented by IAWC and Staff.

The Commission notes that witnesses for Staff and the AG/JM proposed certain adjustments to rate base that were ultimately agreed upon by IAWC, Staff and the AG/JM. Those adjustments include several adjustments to the cash working capital requirement, an adjustment to plant placed in service during 2009 and 2010, and an adjustment to tank painting expense. Additionally, Staff recommended that the Commission make a finding in this Order that the Company's December 31, 2008 plant balance reflected on Company Schedule B-5 Second Revised, page 3 of 24 be approved for purposes of an original cost determination, subject to any adjustments ordered by this Commission. IAWC did not oppose this recommendation.

The Commission finds that the positions of the parties in these resolved issues are reasonable, supported by the record, and are hereby approved.

Contested rate base issues are discussed below. The Commission observes that the summaries of parties' positions on rate base issues, and all other issues, wherever they may be contained in this order, are not intended to reflect the opinions of or determinations by the Commission unless otherwise noted.

A. Cash Working Capital

The following summary of the Company's cash working capital proposal is contained in IIWC's Initial Brief, pages 24-25. According to the Company, the utility earns a return on the cash working capital allowance which represents the capital required for business operations during the period between the point in time when the utility's service is provided, and the point in time the utility is paid for that service. (IAWC Ex. 6.0SR at 2) The Company states the amount of cash working capital allowance it requested in this case was determined by the use of a lead-lag study. (IAWC Ex. 6.0SR at 3)

The lead-lag study was used to review the time between the date customers receive service from the Company and the date payments from those customers are made available to the Company, the lag time. (IAWC Ex. 6.0SR at 3) This lag time is offset by the period between the date the Company receives a good or service and the date the Company pays for that good or service, the lag period. This "lead" and "lag" are measured in days. (IAWC Ex. 6.0SR at 3-4)

Next the Company divided the annual expense for the test year by 365 days to derive a daily cash working capital requirement. (IAWC Ex. 6.0SR at 4) The Company then multiplied the daily cash working capital requirement by the dollar weighted lead and lag days. This final calculation determined the amount of cash working capital to be included in the Company's rate base in this case. (IAWC Ex. 6.0SR at 4)

The Company states that it calculated its revenue collection lag by dividing the Accounts Receivable in 2005 by the daily revenue of 2005 for each District. (IAWC Ex. 6.0SR at 4) Based on these calculations, the Company requested a cash working capital allowance of $5.65 million for the entire company and $3.19 million for Rate Zone 1 with Champaign. (IIWC Ex. 1.0 at 66)

1. IIWC's Position

In IIWC's view, the Company has overstated its cash working capital allowance for several reasons. (IIWC Initial Brief at 25-26) Adjusting the cash working capital allowance to correct for these problems reduces the cash working capital requirements for the total company to a negative balance of $2,000 and for Rate Zone 1 with Champaign, to a negative balance of $493,000. (IIWC Ex. 1.0 at 71) The adjustment of the cash working capital allowance balances as recommended by IIWC would lower the revenue requirement for the Company by $607,044 and for Rate Zone 1 with Champaign specifically, by $395,707. (IIWC Ex. 1.0 at 71-72)

First, IIWC argues that the collection lag in IAWC's analysis is overstated for several reasons, one of which is inconsistency with the Commission's rules. (IIWC Initial Brief at 26-28) The Commission's rules provide that for residential service, the due date for payment of customer bills may not be less than 21 days after the postmark on the bill, if the bill is mailed, or the date of delivery, if the bill is delivered by other means. (83 Ill. Adm. Code Section 280.90) For non-residential customers, the due date for payment may not be less than 14 days. However, the Company's cash working capital allowance assumes a collection lag that ranges from 30.62 to 24.09 days. (IIWC Ex. 1.0 at 69) The collection lag recommended by IIWC is 21 days and is based on the Commission's rules. (IIWC Ex. 1.0 at 69)

The collection lag calculated by the Company assumes its residential and non-residential customers do not comply with the Commission's established minimum time periods for payment of their bills. The Company argues that because it was required to waive late payment fees for residential customers once every 12 months, it was justified in establishing a revenue collection lag period that was significantly in excess of the period specified for payment in the Commission's rules. However, the Company ignores the fact that the 21-day collection lag period recommended by IIWC is more than a third longer (7 days) than the period specified in the Commission's rules for the payment of non-residential customer bills (14 days).

The collection lag period recommended by IIWC is actually greater than the average collection period specified in the Commission's rules and the Company's tariffs. (IIWC Ex. 3.0 at 33) Furthermore, if the Company had actually identified a cost associated with payment of late fees, inclusion of such a cost in its cost of service may have been appropriate. However, the Company did not try to estimate the cost associated with the one-time per year waiver of late payment fees for residential customers, in the test year in this case. The fact that the Company did not include this cost in its test year cost of service, when it could have, does not entitle it to overstate the revenue collection lag period in order to increase its cash working capital allowance. (IIWC Initial Brief at 27)

According to IIWC, the Company also overlooks that residential customers have an incentive to pay their bills on time because of the ability of the Company to charge them a late payment fee the other 11 months of the year. Non-residential customers, who apparently are not entitled to a once a year waiver of their late payment fees, also have an incentive to pay their bills in a timely fashion. (IIWC Ex. 1.0 at 69) Under these circumstances, IIWC's recommended 21-day revenue collection lag period is conservative, consistent with the Commission's rules, and should be adopted.

IIWC's next argument in support of its position that the collection lag in IAWC's analysis is overstated is that the lag for the Champaign and Lincoln districts is not properly calculated. (IIWC Initial Brief at 28-30) The Company has assumed a two-month billing cycle for these districts. This is not consistent with the Company's proposed monthly tariff rates for these two districts, in IIWC's view. To be consistent with the Company's proposed rates, the service period for these two districts should be based on monthly service periods of 15.25 days, the same as the Company's other districts. The workpapers provided by the Company supporting its cash working capital allowance do not explain or support the revenue lag days used for the Champaign and Lincoln Districts. Thus, IIWC argues, the Company's claim that it adjusted revenue lag days for Champaign and Lincoln for a monthly billing cycle cannot be validated. (IIWC Initial Brief at 28; IIWC Ex. 3.0 at 32)

IIWC's third argument in support of its position that the collection lag in IAWC's analysis is overstated is that there are flaws in the Company's calculation. (IIWC Initial Brief at 29) The Company claimed it had supported its calculation of the revenue collection lag by using actual customer data from 2005, measuring the collection period for each of its Districts using billed revenue, average daily accounts receivable balances, and the daily billing revenue for the customers in those districts. (IIWC Ex. 3.0 at 34) However, IIWC asserts, there were flaws in the Company's analysis of that data. Initially the Company estimated a collection lag of 30.62 days and 35.88 days for the Champaign and Lincoln Districts, respectively. The calculations for these two districts were done differently than all of the Company's other districts. Had the Company calculated the collection lag for these two districts in the same fashion as it did for the other districts, it would have calculated a collection lag of 15.31 days for Champaign and 17.94 days for Lincoln. According to IIWC, by overstating the collection lag period for these two districts, the Company overstated its cash working capital balance.

In addition, the Company's analysis used only data from calendar year 2005, but the Company makes no showing that 2005 was a normal year for collection of company revenues. Absent such a showing, IIWC asserts, the Company's analysis is problematic. (IIWC Ex. 3.0 at 35)

IIWC's final argument in support of its position is that the Company made no allowance for uncollectible expenses in either the accounts receivable balances, or the average revenue collections. (IIWC Initial Brief at 29-30; IIWC Ex. 3.0 at 35) The Company included uncollectible expense in its calculation of its cash working capital requirements. However, the Company will never recover this revenue, and it will never be available to support the Company's cash working capital requirements. Furthermore, customers who do pay their bills on time pay an increased rate to the Company in order to make the Company whole for this expense. (IIWC Ex. 3.0 at 35)

IIWC also argues that the Company's cash working capital allowance is inflated because of prepayments to Its Service Company affiliate. (IIWC Initial Brief at 30-32) The Company's cash working capital study is based on the premise that it prepays fees for all services rendered to it by its affiliate, American Water Works Service Company. Because there is a lag between the prepayment of these fees by the Company and the receipt of revenues from the Company's customers, to cover that prepayment, the Company's cash working capital allowance is increased accordingly.

In IIWC's view, the prepayment has not been shown to be consistent with payment terms for the receipt of similar services from third-party suppliers and is therefore not commercially reasonable. (IIWC Ex. 3.0 at 38-39) IIWC recommends the Company's study be modified to reflect a commercially reasonable 15-day lag between the date the services are rendered by the Service Company and the receipt of the revenues needed by the Company to reimburse itself for the payments made to the Service Company.

IIWC says the Company argues that its agreement with the Service Company, including the prepayment provisions, have been previously approved by the Commission. (IAWC Ex. 6.0SR at 5-6) As part of its argument, the Company alleges that:

> . . . without prepayment, the Service Company would have to incur costs to fund services provided to IAWC and pass on these costs as overhead to the Service Company charges to IAWC. As a matter of 'ratemaking policy', the Commission has determined the provision of funds to support services provided by the Service Company is more appropriately met through prepayment terms. (IAWC Ex. 6.0SR at 7)

However, in one of the Orders cited by the Company for the proposition that the Commission has specifically approved prepayment to the Service Company, and that without such prepayment the Service Company would have to pass on the cost of funding services to the Company as overhead in the Service Company charges to the Company, the Commission notes:

> In accordance with Section 2 of the Services Agreement the costs (including applicable overhead) that are included to benefit IAWC alone . . . are assigned, where possible, based on a direct charge and, where

> direct charge is not possible, the costs (and overheads) are allocated among those affected operating subsidiaries based upon the relative number of customers served by each of the subsidiaries. (Emphasis added). (Illinois-American Water Company, Docket No. 04-0595, October 19, 2005, Order at 2)

Therefore, IIWC argues, the Company failed to provide any evidence that the Service Company charges to IAWC did not already include Service Company overheads. Hence, the Company's argument that absent prepayment, overheads would have to be included is, at best, pure conjecture. Under the circumstances, IIWC's recommendation to include a 15-day lag for payments made to the Service Company, in the context of determining the Company's cash working capital allowance, should be adopted.

In support of the IIWC position, Intervenors Homer Glen et al. (Municipalities), in their Initial Brief, assert that the Company's lead-lag study should be adjusted as recommended by IIWC witness Mr. Gorman. (Homer Glen Initial Brief at 15)

The Commission notes that the reasonableness of the amount of management fees paid to the Service Company is discussed in the section of this Order addressing the operating statement.

2. The AG's Position

The AG also takes issue with IAWC's calculation of the revenue collection lag in its lead-lag study. (AG Initial Brief at 13-15) In the AG's view, the Commission should remove the effects of the "improper assumption" that the Company, on average, receives payment from consumers several days after the due date on the bill. This component of the lead-lag study is distorted, the AG contends, because IAWC used 2005 data that is outdated and does not reflect improved collections and because IAWC failed to remove the effect of uncollectibles, which by definition have an unusually long collection lag. (AG/JM Ex. 5.0 at 19-21) In addition, IAWC failed to differentiate the collection lag among various customer groups, effectively charging residential customers for the payment lag of a few large users.

The Company used a revenue collection lag of 24.09 to 30.62 days, which effectively assumes that customers on average pay their bills late. (AG/JM Ex. 5.0 at 21) Under Commission's rules, residential customers have 21 days to pay a bill from the utility and commercial customers have 14 days from the mailing date. 83 Ill. Adm. Code 280.90. The Company's cash working capital calculation effectively asks consumers to pay carrying costs for a revenue collection lag that assumes that, on average, customers pay late. According to the AG, that is unfair to consumers and does not accurately reflect when payments are actually made.

The Company argues that its calculation does not imply that customers "on average" pay their bills late. (IAWC Ex. 6.00 SR at 15-16) However, the effect of the

Company's approach is that customers pay the cost for cash working capital as if, on average, customers pay their bills late. According to the AG, the fact that some customers drive up the collection lag, particularly given Company testimony that a few relatively large customers are responsible for a "significant portion" of outstanding accounts (IAWC Ex. 6.00 SR at 11), makes it more unfair that all customers must pay increased rates as a result of an inflated revenue collection lag calculation. AG/JM witness Smith provided the revenue collection lag for each district, which, the AG asserts, more fairly calculates and allocates the revenue collection lag. (AG Initial Brief at 14; AG/JM Ex. 5.0 at 22)

AG/JM witness Smith also pointed out that the Company used 2005 data in its lead-lag study. Although Company witness Kerckhove defends the use of such information as a cost savings mechanism (IAWC Ex. 6.00 SR at 18), in 2005 there were substantial billing problems, which became the subject of a complaint against IAWC by the People of the State of Illinois and the Village of Homer Glen. In Docket Nos. 05 0681/06-0094/06-0095 the Commission addressed improper back-billing by IAWC that resulted from its meter replacement program in the Chicago Metro District. (Docket Nos. 05-0681/06-0094/06-0095, (Cons.) (April 18, 2007), Order at 22-27) The Commission also addressed customer service deficiencies that made it difficult and time-consuming for customers to have billing disputes resolved. In the AG's view, the Commission should reject the use of 2005 data in light of these documented billing problems which resulted in customers paying less than the billed amount while disputes related to the meter exchange were investigated.

The revenue collection lag calculated by the Company also overstates the collection lag by failing to make an adjustment to remove the effect of uncollectibles, the AG argues. Although the Company agrees that uncollectibles should be excluded from the calculation of cash working capital, subtracting the amount of uncollectibles from revenue in the lead lag study is only part of the needed adjustment; the other part of the needed adjustment, which AG-JM witness Smith and IWCC witness Gorman have both identified and discussed, is to correct the collection lag itself to reflect a collection lag period that is no longer than the payment due date. (AG Initial Brief at 15)

The AG also disputes IAWC's reflection of prepayments of management fees to the Service Company in the calculation of the working capital allowance. The agreement that IAWC relies upon does not mandate prepayment, in the AG's view. Rather, it states that the Service Company shall render a bill "as soon as practicable after the last day of each month . . . for all amounts due from Water Company for services and expenses for such month plus an amount equal to the estimated cost of such services and expenses for the current month." (AG Initial Brief at 15)

The language implies that the Service Company may bill some amounts at the end of the month and other expenses at the beginning of the "current month," without specifying which services can be billed "for the current month" or specifying the time for payment.

AG/JM witness Smith testified that the West Virginia Public Service Commission recently addressed an identical argument by West Virginia American Water Company, where it adopted the argument of the state Consumer Advocate Division ("CAD") to apply IAWC's 12 day lag for direct payroll to its Service Company payments, and refused to allow the utility to include a payment lag in cash working capital for pre-payment to the affiliated Service Company. The West Virginia PSC stated:

> The Commission is not persuaded that the CAD recommendation is unreasonable or requires actions on the part of the Company that violate its agreement with AWWSC [American Water Works Services Company]. The agreement allows AWWSC to provide a current bill 'as soon as practicable' after the last day of each month. It also provides that AWWSC provide an estimate of the bill for the next month. However, there is no provision for advance payments of the next monthly bill. While WVAWC should not act unreasonably in making payments to AWWSC, a lag comparable with its own payroll lags does not appear to be unreasonable, while an advance payment does appear to be unreasonable. The Commission will adopt this CAD adjustment to the Cash Working Capital. (AG/JM Ex. 5.0 at 24, quoting Case No. 08-0900-W-42, Order at 35-36 (March 25, 2009) . . . .

AG/JM witness Smith recommended that the same adjustment be made in this case. He applied the same 12 day payroll lag as a reasonable payment lag for payments to IAWC's affiliated Service Company. The Commission should modify the Company's lead lag study to reflect this more reasonable and fair payment lag and to avoid requiring ratepayers to first pre-pay IAWC's affiliate and then pay a return on the cash used to pre-pay the affiliate. (AG Initial Brief at 15)

3. Staff's Position

Staff witness Mr. Kahle initially supported certain of the recommendations offered by IIWC and AG. However, at the hearing, Mr. Kahle testified, "After reviewing the surrebuttal testimony of the company witness Kerckhove, I am no longer sponsoring my proposed adjustments to cash working capital that appear from lines 153 through 230 of my revised rebuttal testimony." (Tr. 574)

4. IAWC's Position

In its initial and reply briefs, IAWC responds to Intervenors' arguments. First, IAWC argues that use of the 2005 lead/lag study is appropriate. (IAWC Reply Brief at 6) AG and IIWC express concern with IAWC's use of 2005 data in connection with the lead lag study; however, the record shows that the lead-lag study in this proceeding was based on the lead-lag study that was used in the prior rate case, Docket No. 07-0507, and utilized the most recent fiscal year data available at the time that the prior rate case was being prepared. The lead-lag study revenue collection analysis utilized in Docket No. 07-0507 was accepted by the Commission in that proceeding. In addition, the

Commission's rules regarding customer payments, including the late payment fee amount and late payment rules, have not changed between 2005 and the present. (Id.) Therefore, IAWC argues, the Company's decision to rely on the 2005 study was reasonable and should be approved.

The AG suggests that the lead-lag study's use of 2005 data is improper because there were "substantial billing problems" in Chicago Metro in 2005. (AG Initial Brief at 14) According to IAWC, no witness in this proceeding, however, testified that billing problems in Chicago Metro in 2005 affected the lead/lag study. Moreover, neither the AG, nor any witness, suggests that there were "billing problems" outside of Chicago Metro in the rest of IAWC's districts. (IAWC Reply Brief at 6)

Next, IAWC argues, IIWC and the AG concerns that the revenue collection lag is overstated should be rejected. (IAWC Reply Brief at 7-11) AG and IIWC believe that the Company's collection lag should be limited to 21 days because the Commission's rules and Company tariffs require that the due date for residential customer payments be "at least" 21 days after the date printed on the bill.

In IAWC's view, the position of these parties is not based on a calculation of collection lags and ignores the purpose of CWC, which is to compensate the utility's investors for providing the funds required for those day-to-day business operations that require a cash outlay during the lag time between the provision of service and the receipt of revenues associated with that service. (IAWC Ex. 6.00SR at 2) Rather, IAWC contends, AG and IIWC improperly seek to replace IAWC's detailed projection of its revenue collection lag days, which is based on the lead/lag study and reflects the Company's projection of the lag between issuance of bills and receipt of customer revenues, with an arbitrary projection of collection lag days based solely on the Commission's rules regarding payment terms for one customer class, the residential class. IAWC claims their proposal ignores the effect of payment lags from classes other than the residential class and the effect of lags from large government or institutional customers, as discussed above. In addition, IAWC argues, the proposal ignores the fact that IAWC incurs costs related to customer late payment and is entitled to recover those costs.

As the Company's lead-lag study demonstrates, the projected collection lag is 24.09 to 34.71 days (excluding Champaign and Lincoln) for all customers at IAWC. (IAWC Ex. 6.00SR at 9) This projected collection lag reflects IAWC's historical collection experience, including late payments. Because IAWC's projected collection lag is based on a detailed calculation using IAWC's actual collection lag experience, AG and IIWC's arbitrary substitution of a 21 day collection lag should be rejected.

Moreover, IAWC asserts, AG and IIWC's position is based on an incorrect premise that a collection lag of more than 21 days indicates that IAWC's customers are, on average, paying their bills late. In addition, the AG claims that, if a few large customers are responsible for a significant part of outstanding accounts, it is unfair that all customers "pay increased rates as a result of an inflated collection lag calculation."

(AG Initial Brief at 14) The assertions of IIWC and AG suggest that they believe the nature and extent of late payments by customers are somehow within IAWC's control. According to IAWC, this is incorrect; IAWC's practices with respect to late payments are governed by Commission rules, which AG and IIWC ignore.

There are comprehensive practices and procedures, established by the Commission in Part 280 of the Commission's rules, 83 Ill. Adm. Code Part 280 ("Part 280"), through which IAWC and other Illinois utilities may collect amounts due from residential and non-residential customers. (IAWC Initial Brief at 19-20) Part 280 sets forth the terms under which IAWC may pursue the collection of overdue bills and the amount of the late payment charge. For example, Section 280.90 sets the amount of a late fee that a utility may charge: "such charge shall be set at an amount equal to 1½% per month on any amount, including amounts previously past due, for utility service which is considered past due under this Section." Similarly, Section 280.90(h) sets forth rules regarding payment rules for government agencies: "No late payment charges shall be assessed on the amounts owing on units of Federal, State, County, and local government (including, but not limited to, townships, municipalities and school districts) until 45 days from the date of the issuance of the bill for utility service . . . ."

IAWC claims a significant portion of its outstanding accounts receivable in excess of 21 days is represented by state government agencies, such as the Illinois Department of Corrections and the Logan Correctional Facility. Other governmental entities, including neighboring municipalities that purchase water from the Company such as the Caseyville Water Company, maintain large outstanding balances in excess of 21 days that drive the collection day lag up. Thus, the large payment balances and 45-day payment period for these customers is, at least in part, responsible for the weighted average collection lag calculation of more than 21 days (which, under the applicable rules, could result even if all customers paid their bills on time, which they do not). (IAWC Reply Brief at 9)

Moreover, IAWC argues, AG and IIWC's proposed limitation of the collection lag overlooks IAWC's projected test year cost for late payments from all customer classes, and seeks to replace it with a cost arbitrarily limited by the payment period set forth for residential customers in Part 280. (IAWC Initial Brief at 19-20) The costs related to late payments represent an operating expense of the Company (and when past due bills become uncollectible, the Company recovers the cost related to uncollectible bills as an operating expense – uncollectible expense). (IAWC Initial Brief at 20) When a customer pays late, IAWC does not timely receive the revenues from that customer to provide service and must obtain the equivalent funds necessary for working capital from another source of funds. A portion of the cost of late payments is the cost associated with having to obtain cash working capital to fund necessary service when payments are not made on time. The Company incurs the cost related to obtaining the needed funds, and this cost is reflected in rates through inclusion of a cash working capital allowance, based on the lead/lag study, in rate base. (IAWC Reply Brief at 9-10)

IAWC responded to two additional issues, related to the collection lag, raised by IIWC. (IAWC Reply Brief at 10-11) First, IIWC asserts that IAWC has not properly calculated the monthly lags for Champaign and Lincoln to reflect the switch to monthly billing for those districts. As IAWC witness Kerckhove explained, the lead-lag study already reflects the impact of moving Champaign and Lincoln from bi-monthly billing to monthly billing. Since the Company does not have actual history for the lags associated with monthly billing in the Champaign and Lincoln districts, the Company utilized the weighted average of lag days from all of the other IAWC districts.

IAWC complains that the analysis of IIWC witness Gorman, on the other hand, used revenue lags and service period lags for Champaign and Lincoln that do not reflect the conversion to monthly billing. In addition, Mr. Gorman's proposed collection lags for Champaign and Lincoln erroneously use the collection days pertaining to bimonthly billing rather than service period days in his calculation, making his calculation of the Champaign and Lincoln collection days inconsistent with the calculation in the other districts, in IAWC's view. The formula originally used to calculate the collection days for Champaign and Lincoln included a factor to account for bimonthly billing. Mr. Gorman's proposal, therefore, doubles the effect of the bimonthly billing factor and artificially cuts the collection period in half, IAWC's contends.

AG/JM witness Mr. Smith also recommended that the service period used to determine the revenue lag in the Champaign and Lincoln districts be adjusted in the Company's lead-lag study to reflect the transition from bi-monthly to monthly billing. According to IAWC, after reviewing Mr. Kerckhove's rebuttal testimony, Mr. Smith determined that the Company's lead-lag study already reflects the transition from bi-monthly to monthly billing for the Champaign and Lincoln districts, and concluded that no further adjustment is necessary. (IAWC Reply Brief at 11; AG/JM Ex. 5.0 at 25)

IIWC also suggests that IAWC improperly made no allowance for uncollectible expense in its cash working capital calculation. As IAWC explained in its initial brief, pages 11-12, AG/JM witness Mr. Smith had recommended that the total amount of adjusted uncollectibles be removed from the cash working capital revenue calculation. (AG/JM Ex. 1.0 at. 28) The Company agreed and adjusted its cash working capital calculation accordingly. (IAWC Ex. 6.00R2 at 7) With respect to IIWC's recommendation, as Mr. Kerckhove explained, no other allowance is necessary. (IAWC Ex. 6.00SR at 18) Because uncollectibles expense is a separate operating expense line item, uncollectible expense is netted with revenues to reduce the revenue lag. To further adjust revenues for uncollectibles would double count the effect of uncollectibles in the calculation of cash working capital. (IAWC Reply Brief at 11)

IAWC next takes issue with what it refers to as assertions by the AG, IIWC and the Municipalities that IAWC's CWC calculation should be adjusted to remove the effect of prepayment to the Service Company. (IAWC Reply Brief at 11-14) According to IAWC, these assertions do not recognize that the Commission-approved agreement between IAWC and the Service Company ("Service Company Agreement") requires prepayment of Service Company fees, and that this approach eliminates a Service

Company overhead cost that IAWC would otherwise be required to pay as a part of the cost for services provided. (IAWC Ex. 6.00SR at 4-5)

As IAWC explained in its Initial Brief, page 22, the Service Company, unlike other vendors, provides services at cost. It has no retained earnings or other internally generated funds with which to provide working capital to fund the services it provides to IAWC prior to receipt of payment for those services. (IAWC Ex. 6.00SR at 5) Thus, in preparing the Service Company Agreement, there were two options for addressing the Service Company's need to obtain funds in order to provide the necessary funds to finance required services used by IAWC. One option was to have the operating utilities, such as IAWC, prepay for Service Company services. The other option would have been to require the Service Company to obtain cash working capital and include the related cost in the overheads added to the cost for services provided to IAWC and other operating subsidiaries. In the Service Company Agreement, the option to have the operating utilities, including IAWC, prepay for Service Company services was used. IAWC does in fact prepay Service Company charges, and this prepayment is reflected in IAWC's lead-lag study and cash working capital calculation. (IAWC Ex. 6.00SR at 6-7)

According to IAWC, the current Service Company Agreement, which includes a provision for pre-payment for monthly services, has been approved by the Commission twice: on July 19, 1989, in Docket No. 88-0303 and again on October 25, 2005, in Docket No. 04-0595. (IAWC Reply Brief at 12-13) In approving the Service Company Agreement, the Commission found that the Service Company Agreement was reasonable and in the public interest. If the approved Service Company Agreement had not required prepayment for services, IAWC's cost to obtain services from the Service Company would have been different. (IAWC Ex. 6.00SR at 6) Thus, IAWC argues, the prepayment terms are reasonable and should not be modified.

The AG also argues that the Service Company Agreement does not in fact require prepayment, and the Municipalities cite a West Virginia Public Service Commission ("PSC") Order that they allege finds, with respect to an agreement between the Service Company and an affiliate of IAWC, that there is no provision for advance payments of the next monthly bill. These assertions, however, are contradicted by the express terms of the Service Company Agreement, in IAWC's view. Under the Service Company Agreement, IAWC is contractually required to prepay the Service Company for services. The Service Company Agreement provides: "As soon as practicable after the last day of each month, Service Company shall render a bill to Water Company for all amounts due from Water Company for services and expenses for such month plus an amount equal to the estimated cost of such services and expenses for the current month." (IAWC Ex. 5.01 at 11)

In IAWC's view, the quoted language requires that the bill from the Service Company include two amounts: (1) amounts due; and (2) an amount equal to the estimated cost of such services and expenses for the current month. Further, the Service Company Agreement continues, "[a]ll amounts so billed shall reflect the credit for payments made on the estimated portion of the prior bill . . . ." (Id.), confirming that the Service Company Agreement requires advance payment of an estimated amount. Thus, IAWC argues, the Service Company Agreement clearly requires prepayment, and IAWC does in fact pay the current month's estimated Service Company fees in advance. (IAWC Ex. 6.00SR at 23-24)

As a result, IAWC contends, the record in this case demonstrates that it is appropriate for IAWC's CWC calculation to reflect its actual payment practices with respect to Service Company fees. The prepayment terms impose cash working capital requirements on IAWC, which are reflected in the CWC calculation. If some other lead period for Service Company payments were imposed, IAWC would continue to be required to prepay the Service Company for services. IAWC claims the effect of this proposal would be to deny IAWC a reasonable opportunity to recover a cost prudently incurred in providing service in accord with an agreement previously approved by the Commission. (IAWC Reply Brief at 14)

5. Commission Conclusion

As the Commission understands it, IAWC has proposed a cash working capital allowance based, essentially, on the same lead/lag study it presented in Docket No. 07-0507. IAWC has proposed some modifications to that study based upon changes in circumstances since its last rate case and in response to certain complaints of parties in this proceeding. While Staff initially had some concerns with IAWC's proposed CWC calculation during this proceeding, it ultimately accepted IAWC's proposed CWC request. IIWC and the AG have raised several concerns with IAWC's CWC request; those concerns are summarized above and will be addressed below.

IIWC and the AG express concern about the revenue collection lag used by IAWC. They argue that IAWC's assumption means that, on average, its customers pay their bills late, which they believe is an unreasonable assumption. IIWC argues that customers have an incentive to pay their bills on time and it is not reasonable to assume a revenue collection lag greater than the 21 days in which residential customers are allowed to pay their bills. The AG argues that it is not fair to burden all customers with a higher CWC requirement because a few large customers pay their bills late.

IAWC responds that regardless of what the Commission's rules or IAWC's tariffs state, its calculated revenue lag is accurate. IAWC contends that the primary reason its computed revenue lag is so high is that a relatively small number of governmental customers, to which the standard due dates do not apply, have large outstanding bills for relatively long periods of time.

Having reviewed the positions of the parties, the Commission is not convinced that it is appropriate or reasonable to simply assume that 21 lag days should be used because it is the number appearing in the Commission's rules. Also, Section 285.2070 of Part 285 specifically contemplates the use of a lead/lag study. The Commission does not believe that IIWC's assumption regarding customer behavior is consistent with information in the record regarding actual customer behavior. The Commission believes that IAWC has explained why its revenue lag exceeds 21 days. While the Commission understands the AG's fairness concern, the proposal to use 21 revenue lag days ignores what is actually experienced by IAWC. While the Commission might consider a proposal for a different allocation of the CWC responsibility among customer classes in future rate proceedings, it cannot simply ignore a legitimate cost of providing service. The Commission concludes that the Company's proposal is more reasonable than setting the revenue lag days at 21 days, and the 21-day proposal will not be adopted.

The next major issue relates to IAWC's prepayments to the Service Company. IIWC and the AG contend that such a practice is inappropriate and causes the CWC requirement to be overstated. IAWC claims that is appropriate for it to prepay for Services Company services and that doing so allows the Service Company to avoid incurring its own CWC requirement, which would be passed on to IAWC anyway. IAWC also argues that the Commission-approved Service Company Agreement requires IAWC to prepay for Services Company services. Finally, IAWC claims that because the Service Company agreement requires it prepay for services, if the Commission were to make an adjustment to the CWC requirement, it would be denied the opportunity to recover the reasonable cost of providing utility service.

The Commission is sensitive to concerns that affiliated interest transactions have the potential to have adverse consequences for ratepayers. It does not appear that in this instance any party is arguing that IAWC's actions are prohibited by the Services Company Agreement. Instead, the argument is that IAWC's CWC requirement could be lowered if it did not prepay for Service Company services. While that argument may be correct as far as it goes, there are other consequences to consider. If IAWC did not prepay for Service Company services, the cost would be shifted to the Service Company. Because the Service Company Agreement allows the Service Company to pass its costs directly on to IAWC, Illinois-American could not actually avoid the cost and ratepayers would ultimately be responsible for the costs. As a result, the Commission sees no benefit to ratepayers from modifying the CWC requirement to address this concern and the proposal to do so is hereby rejected.

As explained above, the AG expresses concern about relying on the 2005 lead/lag study, arguing in part, that there were problems associated with the billing data for the Chicago Metro area in 2005. The Commission notes that the 2005 lead/lag study formed the basis for rates in Docket No. 07-0507. While there may be benefits to having an updated lead/lag study, the record does not contain such a study. In the Commission's view, there is no viable alternative to the using IAWC's lead lag study as the starting point for estimating the CWC requirement. The Commission does not believe the record supports rejecting IAWC's lead/lag study.

IIWC and the AG also complain that the lead/lag study does not correctly reflect the transition from bimonthly to monthly billing in the Champaign and Lincoln districts. IAWC provided testimony explaining how its lead/lag study was modified to reflect the transition from bimonthly to monthly billing in those two districts. Based upon its review of the record, the Commission concludes that IAWC has reasonably reflected the transition to monthly billing in the Champaign and Lincoln districts. It appears to the Commission that a further adjustment to the lead/lag study is unnecessary and the proposals to do so are not adopted.

The final area of concern regarding IAWC's lead/lag study relates to the treatment of uncollectibles. IIWC and the AG believe that the lead/lag study should exclude the impact of uncollectibles. As the Commission understands it, IAWC agrees and has modified its lead/lag study to remove the impact of uncollectibles.

B. Business Systems Planning Study

1. The AG's Position

In its direct case, IAWC included in rate base a corporate study of business practices in both 2009 and 2010. In AG/JM Exhibit 1.0 at pages 22-25, the double count was identified, and the Company removed the double count. However, it left in rate base $625,240 for Illinois' share of a study conducted by its parent company, American Water Works Corporation, to "assess the needs of our business, to satisfy customer and other stakeholder expectations, and to review different technology options to support the implementation of automated processes that provide improved service to our customers." (IAWC Ex. 5.00 R2 at 6) The AG recommends that this amount, $625,240, be removed from rate base. (AG Initial Brief at 16-19)

According to the AG, the questions before the Commission are: (1) is it appropriate to spend money on a study of this kind when consumers are seeing repeated, double-digit increases in their bills and many are facing unemployment and recession and (2) are IAWC's customers being asked to shoulder an excessive portion of a study that appears to duplicate the services that are supposed to be provided by the Service Company.

The "Comprehensive Planning Study" ("CPS") that IAWC would like to include in rate base is an example of the kind of expenditure that should not be included in a rate increase request as large as the one sought in this docket, the AG argues. The kinds of review to be done by the report, as described by IAWC witness Grubb at IAWC Exhibit 5.00 R2 at 6, appear to duplicate the services provided by the Service Company and for which IAWC seeks more than $20 million. IAWC witness John Young discusses these services at length in IAWC Ex. 12.00, and identifies the following 10 areas where the Service Company purportedly offers expert, management services: Communications and External Affairs, Corporate Finance, Customer Service Center, Divisional Operations Support and Regulated Operations, Human Resources, Information Technology Services, Legal, Operations Services Department, Shared Service Center, and Other Services. Yet, despite all of this expertise and service allegedly available through the Service Company, IAWC is asking consumers to fund a separate, third-party study of the same business practices that the Service Company is supposed to provide.

In the AG's view, this is the kind of "extra" management review that ratepayers should not be expected to fund when they are already paying among the highest rates in the state. IAWC should be trying to keep costs down – not spending more than half a million dollars on a study to tell them how to run their business. The Commission should remove $625,000 for the Comprehensive Planning Study from rate base.

In addition, the AG argues, IAWC has not adequately justified paying $625,000 for its share of this American Water Works study. In response to AG data request 9.16, excerpts of which were admitted as AG Cross Exhibit 21, IAWC was asked for the total cost of the study. In response, IAWC only included the amount IAWC was including in rate base, preventing parties from determining whether the allocation to Illinois was fair. In addition, IAWC provided copies of the contracts with vendors who were doing the study. A list of their charges is included in AG Cross Exhibit 21.

The total charges included in the contracts produced by IAWC for the American Water Works study was $2,239,000. (AG Cross Ex. 21) Illinois ratepayers are being asked to pay $625,240 of that amount, or 27.9%. However, IAWC only serves about 9% of all American Water Works customers. (Tr. at 473) Mr. Grubb said he believed IAWC represented more than 9% of American Water's regulated customers, suggesting that IAWC customers "could be 15, 16 percent." (Tr. at 474) Irrespective of whether IAWC customers represent 9% or 16% of American Water's total customers, IAWC has not justified allocating 27.9% of the Comprehensive Planning Study costs to Illinois, in the AG's view. According to the AG, the absence of a justification for the allocation of $625,240 to Illinois requires that this cost be removed from rate base. (AG Initial Brief at 18-19)

2. IAWC's Position

IAWC disputes the AG's recommendation to disallow the cost of the study. (IAWC Initial Brief at 14; Reply Brief at 14-16) According to IAWC, no witness in this proceeding recommended that such a disallowance be made; nor has any witness testified that IAWC's investment in the CPS was imprudent. Moreover, no witness has testified that the cost of the CPS is excessive or that it duplicates Service Company services. In fact, as discussed below, the CPS is intended to study ways to enhance the services provided by the Service Company to IAWC's customers.

AG/JM witness Smith initially suggested that the cost of the CPS was being double-counted. (AG/JM Ex. 1.0 at 24-25) In response, IAWC witness Kerckhove pointed out that the double-counting error was corrected in the Company's Errata filing on September 22, 2009. (IAWC Ex. 6.00R2 at 6) As a result, IAWC asserts, Mr. Smith did not recommend exclusion of the CPS cost from rate base. (AG/JM Ex. 5.0 at 17-18) Moreover, in IAWC's view, the record demonstrates that the CPS is necessary, and will review operational and system changes that will benefit customers.

Mr. Grubb stated that American Water began the CPS in the first quarter of 2009, and that its cost is being allocated to all the regulated entities of American Water based on customer count. (IAWC Ex. 5.00R2 (Rev.) at 6-8) IAWC's projected allocation for the test year is $625,240. The purpose of the CPS is to satisfy IAWC customer and other stakeholder expectations, and review technology options to support the implementation of automated processes that provide improved service to customers.

The impetus for the study was a general recognition that the systems and processes at American Water, which support many of IAWC's processes, were at the end of their useful life cycle, because: (1) they were designed to accommodate a much smaller customer base; (2) they are increasingly costly to maintain and support; and (3) customer expectations for service are different than they were when the existing systems were acquired. American Water has undertaken a program to streamline and automate processes, and to remove inefficient manual tasks, controls and processes, in order to enhance IAWC's provision of service to its customers. As part of the CPS, American Water has conducted an internal evaluation of processes, along with the information systems associated with those processes. The CPS therefore represents a prudent investment by IAWC in enhancing its business processes, and the cost should be allowed in rate base, according to IAWC. (IAWC Reply Brief at15-16)

3. Commission Conclusion

The AG objects to IAWC's proposal to include in rate base the costs associated with the Comprehensive Planning Study, $625,240. The AG also suggests that even if the costs are not disallowed in their entirety, IAWC is proposing to recover too large a portion of the costs from Illinois ratepayers.

IAWC argues that the costs associated with the CPS benefit ratepayers and are prudent. IAWC says no witness claims the costs are excessive and believes that such costs should be included in rate base.

While the Commission understands the AG's view that expending money on studies such as the CPS contributes to higher rates, all corporations must plan for the future. The Commission believes that in the long run, customers benefit when utilities engage in such planning. Here, the Company has explained why the CPS is beneficial to customers. The evidentiary record does not support a finding that the cost of the CPS should be disallowed as duplicative or unnecessary, and the Commission will not adopt the AG's recommendation to do so.

Regarding the allocation the CPS cost, the costs associated with the CPS "is being allocated to all the regulated entities of American Water based on customer count" according to Mr. Grubb. (IAWC Ex. 5.00R2 at 6) While the record is not entirely clear, Mr. Grubb suggests that Illinois customers make up 9% to 16% of American Water's customers. (Tr. at 473-74) Given that the total cost of the CPS is $2,390,000 (AG Cross Ex. 21), it appears that the AG is correct that an excessive portion of the costs has been allocated to Illinois. Assuming that Illinois' customer count represents 16% of the American Water's customer count, IAWC's responsibility would be $358,652 rather than $625,400. Therefore, the Commission concludes that IAWC's rate base should be reduced by $266,748, with each rate district's reduction based upon the respective customer count.

C. Approved Rate Bases

Upon giving effect to the conclusions above, the approved rate base for IAWC's Rate Zone 1 is $441,432,766. The approved rate base for IAWC's Chicago Metro Water district is $100,000,575. The approved rate base for IAWC's Chicago Metro sewer district is $45,829,534. The approved rate base for IAWC's Pekin district is $16,396,051 and for its Lincoln district is $9,202,926.

V. OPERATING EXPENSES AND REVENUES

Schedules showing the operating revenues, expenses, and income at present and recommended rates for the test year ending December 31, 2010 were presented by IAWC and Staff. Certain schedules were also provided by the AG.

The Commission notes that witnesses for Staff and the AG/JM proposed certain adjustments to operating expenses that were ultimately agreed upon by IAWC, Staff and the AG/JM. Those adjustments include proposed adjustments to tank painting charges and the amortization of such charges, depreciation expense, advertising expenses, and lobbying expenses.

The Commission finds that the positions of the parties in these resolved issues are reasonable, supported by the record, and are hereby approved. The contested issues are addressed below.

A. Adjustments to Large Industrial Sales Volumes

1. IIWC's Position

IIWC proposes an adjustment to Illinois-American's forecasted test year sales volume, specifically the sales volume for the U.S. Steel-Granite City Works facility, which applies to the Large Industrial Class in the Interurban District of Rate Zone 1 with Champaign. (IIWC brief at 32-35, citing IIWC Ex. 2.0 at 6) In IIWC's view, the Company proposal understates the Granite City Works sales volume for the test year as compared to its historical sales levels as well as actual current sales levels. Forecasting lower than normal test year sales volumes understates the revenues Illinois-American receives from customers under current rates. As a direct consequence, it understates the Company's operating income at present rates, which in turn increases the Company's claimed revenue deficiency, according to IIWC. (IIWC Ex. 2.0 at 4).

The Company proposed to utilize U.S. Steel-Granite City Works' actual water usage for July through November 2009 to project Illinois-American's 2010 test year level of Large Industrial Class usage. (Grubb, IAWC Ex. 5.00SR at 2). The average monthly usage by U.S. Steel during the July to November 2009 period was 135,908 thousand cubic feet ("CCF"), which equates to an annualized usage of 1,630,896 CCF. Although this is a substantial increase in sales volume from the Company's initial proposed annualized usage of 500,000 CCF for U.S. Steel, it does not represent annualized usage based on the most recent or current information available. A four-year historical average of sales volume for U.S. Steel, or the most recent sales volume information (utilizing the average monthly usage by U.S. Steel-Granite City Works during the August to November 2009 time period) demonstrate that the Company-recommended test year sales volume for U.S. Steel remains low and incorrect. (IIWC brief at 33)

Illinois-American, in determining U.S. Steel-Granite City Works annualized usage, has incorporated a month (July 2009) in which Granite City Works was in "hot idle" mode. At the beginning of December 2008 U.S. Steel-Granite City Works went into "hot idle" mode. Hot idle means that production at the plant ceased but most of the cooling water systems remained in operation for freeze protection and corrosion. (IIWC Ex. 5.0 at 2). Water consumption during this time period in which the Granite City Works was in hot idle mode (December 2008 to July 2009) was drastically reduced.

However, as of July 2009 workers began returning to work and U.S. Steel-Granite City Works began to resume mill operations. (IIWC Ex. 2.0 at 6). July was not a full production month. Today, U.S. Steel-Granite City Works has resumed substantially full production. Employment levels, as well as the level of water consumption, have fully returned to historical levels. (IIWC Ex. 5.0 at 6). Therefore, IIWC asserts, U.S. Steel-Granite City Works sales volumes will approximate its historical average annual level. Under the circumstances IIWC offers two methods to determine the annualized sales volume level for the U.S. Steel-Granite City Works.

IIWC's preferred method uses four-year historical annual sales volumes. The four-year average annual sales volume for U.S. Steel-Granite City Works during the period January 2005 through December 2008 is 1,879,879 CCF per year. (IIWC, Grubb Cross Ex. 5). Using a four-year historical annual average allows the Commission to view the previous annual usage levels that IIWC believes are more appropriate for estimating annual usage on a going-forward basis, given the U.S. Steel-Granite City Works' return to full production.

The second method uses August through November 2009 annualized four-month average sales volumes. Illinois-American proposes to utilize U.S. Steel-Granite City Works water usage for July through November 2009 to project the test year sales volume level for U.S. Steel. (IAWC Ex. 5.00 SR at 2) During the July to November 2009 period, average monthly usage was 135,908 CCF, which equates to an annualized usage of 1,630,896 CCF. The Company believes this annualized level is appropriate because they contend it reflects the most current U.S. Steel usage levels available. IIWC agrees with Illinois-American's attempt to reflect the most current usage levels available at U.S. Steel, however, the most current and accurate usage levels for U.S. Steel would exclude the usage for July 2009 which was a partial hot idle month. IIWC Grubb Cross Exhibit 6 is an article from the St. Louis Business journal dated July 8, 2009 indicating U.S. Steel-Granite City Works began making steel on Tuesday, July 7, 2009. The month of July 2009 was not a full production month and usage was 70,644, less than half of the usage for September 2009 (151,616 CCF), October 2009 (161,136 CCF) and November 2009 (173,545). (IIWC Ex. 5.0 at 4; IIWC Grubb Cross Ex. 4)

In order to reflect the most current non-hot idle usage levels at U.S. Steel, the monthly sales volumes for the four-month period of August through November 2009 should be averaged (152,230 CCF) and annualized (1,826,769 CCF). Averaging the monthly sales volumes for four full production months, as opposed to four full production months and one partial production month, is a more accurate indicator of actual annual usage, thus reflecting a more accurate estimate of the future test year sales volume level for U.S. Steel-Granite City Works. IIWC recommends that the test year sales volume for U.S. Steel-Granite City Works be adjusted to no less than 1,826,769 CCF. IIWC continues to recommend and prefer the four-year historical annual average sales volume of 1,879,879 CCF as the most accurate sales volume. (IIWC brief at 35)

The AG agrees with IIWC that the Commission should not rely on a five-month average that contains one month, July, of unusually low demand. (AG reply brief at 9)

2. IAWC's Position

The Company proposes to annualize U.S. Steel's actual water usage for July through November 2009 to project IAWC's 2010 level of large industrial class usage. (IAWC reply brief at 17-18; IAWC Ex. 5.00SR at 2) This equates to an annualized usage of 1,630,896 CCF. Use of this current information is reasonable, in IAWC's view, in light of the recent shift of U.S. Steel out of hot idle mode in July 2009. In addition, IAWC states, in its most recent prior rate case, Docket No. 07-0507, the Commission found that the use of recent revenue data for sales for resale customers was a more appropriate basis for the projection of future water sales than use of an historical average. (Docket No. 07-0507 Order at 12, 14) Because the Company's current estimate is accurate based on recent actual usage data, the Commission should accept it as a reliable indicator of expected test year usage.

According to IAWC, the historical data on which IIWC relies is not a reliable indicator of test year usage, as U.S. Steel (the sole customer in the class) is just now returning to higher levels of production, and therefore water usage capacity, from its hot idle period. Because IIWC's projection is based on historical data that does not reflect recent economic conditions affecting water usage at U.S. Steel and does not incorporate the most recent available actual data, the Commission should reject it in IAWC's view.

IIWC also proposes, as an alternative projection, utilizing the four months of August through November 2009 to calculate an annualized sales volume. IAWC asserts that no witness in this proceeding proposed use of this projection, and that it should be rejected as an arbitrary attempt to increase test year water sales levels to U.S. Steel. As IIWC acknowledges, the hot idle mode ended in July 2009. IIWC claims that July 2009 was a “partial” hot idle month, but admits that U.S. Steel began making steel on July 7, 2009. IIWC’s proposal to drop off July from its average because July’s usage was lower than September or October amounts to a cherry picking of favorable data, in IAWC’s view. According to IAWC, if IIWC’s concern is that, until July 2009, U.S. Steel was in hot idle mode, IAWC’s revised test year projection of sales to U.S. Steel, which includes the months in 2009 for which data is available after U.S. Steel left hot idle mode (July – November), is the most reasonable and appropriate projection. (IAWC reply brief at 18)

3. Commission Conclusion

Because U.S. Steel was not in a full production mode in the first half of 2009, IAWC proposes to annualize U.S. Steel’s actual water usage for July through November 2009 to project IAWC’s 2010 level of large industrial class usage, which equates to an annualized usage of 1,630,896 CCF.

IIWC proposes to annualize the water usage at U.S. Steel using the four-year average annual sales volume during the period January 2005 through December 2008, which provides an estimate of 1,879,879 CCF per year. Regarding the Company’s proposal, IIWC argues that July 2009 is not a representative amount; as an alternative, IIWC suggests averaging U.S. Steel's actual water usage for the four-month period of August through November 2009, which produces an annualized usage estimate of 1,826,769 CCF.

IAWC indicates that U.S. Steel began making steel on July 7, 2009; thus July is an appropriate month to include. IAWC claims IIWC is cherry picking by excluding July data and complains that no witness supported IIWC's alternative proposal.

Having reviewed the record, the Commission concludes that U.S. Steel's annualized water usage should be calculated using the data from August 2009 through November 2009 rather than from July 2009 through November 2009. In July 2009, U.S. Steel was not making steel for approximately six days which represents at least 20 percent of the work days during the month. The table in IIWC witness Mr. Collins' rebuttal testimony indicates that July water usage is significantly lower than the following months. (IIWC Ex. 4.0 at 3) Also, the fact that IIWC's two estimates of U.S. Steel's annualized water usage are nearly the same supports the proposition that IAWC has underestimated the annualized water usage at U.S. Steel. Thus, the record supports calculating U.S. Steel's annualized water usage using the data from August 2009 through November 2009, which produces an annualized usage estimate of 1,826,769 CCF. Since forecasted sales are being increased, a corresponding increase in chemical and purchased power and fuel expense is also made for the Interurban district.

As IIWC explains, under-forecasting test year sales volumes understates the revenues IAWC receives from customers under current rates. As a direct consequence, it understates IAWC's operating income at present rates, which in turn increases IAWC's stated revenue deficiency. Thus the adjustment approved by the Commission, which increases forecasted sales, will provide ratepayer benefits.

The above conclusion regarding sales to U.S. Steel increases annual water sales for the Interurban district by 195,873 CCF. The appendix attached hereto shows the revenue and expense implications of this conclusion.

B. Service Company Fees

For certain functions IAWC maintains its own full-time staff of employees to provide services. For other services, IAWC uses outside service providers, including its affiliated Service Company. The terms related to IAWC’s use of services provided by the Service Company are set out in the Services Company Agreement previously approved by the Commission. (IAWC Initial Brief at 57-58) Under the Service Company Agreement, the Service Company provides services for IAWC at the Service Company’s cost, with no profit component. (Id.; IAWC Reply Brief at 46)

1. IAWC's Position

IAWC witness John Young testified that the Service Company employees are expert in all aspects of the water utility business, and have detailed knowledge and experience specifically with the operations and facilities of IAWC and other American Water operating companies. (IAWC Ex. 12.00)

IAWC also obtains services from outside providers other than the Service Company, such as where the Service Company is unable to provide specialized services needed to address specific situations or where use of a non-affiliate provider is appropriate based on cost or other considerations. (IAWC Initial Brief at 58)

In this proceeding the Company’s requested level of management fee expense, also referred to as service company fees, is approximately $21.167 million excluding incentive compensation, and reflects the cost of the services IAWC is projected to receive from the Service Company in the test year. As discussed below, IAWC witness Mr. Young provided a detailed description of the services that the Service Company provides and the purported benefit of those services to IAWC. As Mr. Grubb explained, the Company’s requested level of management fee expense is based on a detailed, bottoms-up approach to budgeting of the costs for the Service Company to provide services to IAWC in the test year.

In its Order in Docket No. 07-0507, on pages 30-31, the Commission stated:

> Because the Commission questions whether IWAC is doing everything possible to ensure low costs for ratepayers, the Commission directs IAWC to conduct a study comparing the cost of each service obtained from the Service Company to the costs of such services had they been obtained through competitive bidding on the open market. As part of the study, IAWC must also provide an analysis of the services provided by the Service Company to all of IAWC's affiliates. The analysis must provide details on the specific services provided to IAWC and how costs are allocated among affiliates of IAWC. IAWC shall include the study in its next rate filing.

IAWC addressed this requirement through a set of studies and the testimony of five witnesses in the current case (collectively, the "SC Cost Evidence"): IAWC's President, Ms. Teasley; Mr. Mark Young of Deloitte & Touche; Mr. Uffelman of Uffelman Advisory Services; Mr. John Young, President of AWWSC; and Mr. Grubb.

The SC Cost Evidence purportedly shows that for those services that (1) IAWC obtains from the Service Company; and (2) can be obtained from an affiliate or non-affiliate source, the amount paid by IAWC to the Service Company (which is the Services Company's cost ("SC Cost")) is well below the cost that IAWC would be required to pay a non-affiliate provider based on market prices for services. (IAWC Initial Brief at 59)

As part of the SC Cost Evidence addressing the requirements that IAWC "conduct a study comparing the cost of each service obtained from the Service Company to the costs of such services had they been obtained through competitive bidding on the open market," the Company produced the Service Company Cost Study (IAWC Ex. 11.01), which provides a comparative study of Service Company cost and market prices for certain services based on hourly rates. For these services, the SC Cost is also below the cost that IAWC would incur to retain its own employees to provide the services on a stand-alone basis (to "Self Provide"). (IAWC Initial Brief at 59, citing IAWC Exs. 1.04; 5.00 at 4)

As part of the SC Cost Evidence, IAWC also provided the Self-Provision Study (IAWC Ex. 1.04), provided by Ms. Teasley, which compares the cost that IAWC incurs in obtaining services through the Service Company to the cost that IAWC would incur to provide those services with its own personnel; and the Belleville Lab Study ("Belleville Study") (IAWC Ex. 5.04), provided by Mr. Grubb, which supplements the Service Company Cost Study by comparing the cost of performing over 55,000 water quality tests for the American Water system to the cost of obtaining the same tests from three separate independent labs on a per-test fee basis.

Mr. John Young describes the services provided to IAWC and other American Water affiliates. (IAWC Ex. 12.00 at. 2-26) Mr. Grubb discusses the allocation of

Service Company costs between regulated and non-regulated affiliates of the Service Company. (IAWC Ex. 5.00 (Rev.) at 4-11) Mr. Grubb also discusses the basis for IAWC's test year projection of management fee expense.

As IAWC witness Uffelman explained (IAWC Ex. 10.00 at. 4-5), the Service Company Cost Study purportedly provides the required market comparison for services that IAWC can effectively outsource to either an affiliate or non-affiliate provider. For services that cannot be effectively obtained through non-affiliated providers, such as corporate governance, employee benefits management, and customer service center services, a market for such services is not included in the Service Company Cost Study. Rather, they are instead addressed in the Self-Provision Study which compares the "market" cost that IAWC would incur to retain additional IAWC employees to provide services to the cost of obtaining such services from the Service Company. (IAWC Initial Brief at 60)

IAWC contends that the Service Company Cost Study's methodology properly compares "the cost of each service expected to be obtained from the Service Company that can be performed by a non-affiliate to the costs of such services that would be incurred if such services were obtained through competitive bidding on the open market." The Service Company Cost Study relies on market comparison survey data of hourly rates for various services, as well as actual hourly rates charged by third party vendors to IAWC or its affiliates, that represent the cost of those services in the market, i.e., the cost had they been obtained through competitive bidding. (IAWC Initial Brief at 61)

The market surveys contain 2008 information (the most recent annual information available at the time the Service Company Cost Study was prepared) relating to the compensation, fee and billing practices for the five categories of professional services firms. For services like accounting, engineering and legal services, market survey data focused on the Midwest region was used. The market surveys were identified by Deloitte & Touche through research based on certain selection criteria. Based on the research conducted, Deloitte & Touche concluded that the surveys selected each provide a reliable indication of a market price for services covered by the survey.

In addition to market survey data, the Service Company Cost Study utilized what is referred to as "Supplemental Data," which is market price data specifically applicable to non-affiliate services utilized by IAWC and/or other American Water entities. IAWC and American Water utilize a wide variety of services provided by unaffiliated vendors. As a result, Deloitte & Touche had available for the Service Company Cost Study market pricing data specifically applicable to IAWC or American Water for all service categories (Accounting, Engineering, IT, Legal and Management Consulting) of services studied. The Supplemental Data represents actual hourly rates for services such as accounting, legal and engineering services, charged to IAWC or its affiliates by non-affiliated vendors. Many of these hourly rates were the product of competitive bidding conducted by IAWC or American Water or request for proposal ("RFP") processes. (IAWC Ex. 12.00 at 27-28)

Based on the market survey data and Supplemental Data, the Service Company Cost Study projects market costs for services in 2010. The Service Company Cost Study purportedly demonstrates for those services that: (1) IAWC obtains from the Service Company; and (2) can be obtained from an affiliate or non-affiliate source, the amount paid by IAWC to the Service Company is well below the amount that IAWC would be required to pay a non-affiliate provider based on market hourly prices for services that would result from competitive bidding. (IAWC Initial Brief at 62; IAWC Ex. 1.00 at 18) According to IAWC, Exhibit 11.01 indicates that the expected level of savings for 2010, resulting from the procurement by IAWC of services through the Service Company as compared to the level of cost that IAWC would incur to procure services from non-affiliate providers, is approximately $7.69 million. IAWC asserts that no witness in this proceeding has challenged the methodology or results of the Service Company Cost Study. (IAWC Initial Brief at 62)

The Service Company Cost Study is supplemented by the Belleville Lab Study provided by Mr. Grubb. Since laboratory services can also be obtained in the market at a "per test" price, IAWC supplemented the Service Company Cost Study approach for laboratory services with the Belleville Lab Study, which compared the Service Company's projected "per test" laboratory cost to the expected market "per test" cost for the test year. (IAWC Initial Brief at 62-63)

The Belleville Lab Study utilized per-test price data from three outside water quality testing labs for 28 different water quality tests currently being performed by the Belleville Lab. (IAWC Ex. 5.00 (Rev.) at 9) The per-test prices of the outside vendors were adjusted for turnaround surcharges, the electronic data requirements of the tests, the need for limited receipt days for microbial analyses, the need for multiple microbial slides and for sample disposal containers. The study concluded that, on a per-test basis (as opposed to the hourly rate basis examined in the Service Company Cost Study), the American Water system would realize a total savings of $2,305,374 in water quality testing costs in 2010 by performing necessary tests at the Service Company's Belleville Lab, rather than having an outside water quality testing lab perform the tests. Of this savings, IAWC would realize $207,253 in 2010, as shown on IAWC Exhibit 5.04, page 1.

For those services that: (1) IAWC obtains from the Service Company; and (2) can be obtained from an affiliate or non-affiliate source, the amount paid by IAWC to the Service Company, the SC Cost is also purportedly below the cost that IAWC would incur to retain additional IAWC employees to provide the services on a stand-alone basis. (IAWC Ex. 1.00 at 18; IAWC Ex. 1.04) The Self-Provision Study utilized the compensation levels paid by the Service Company for comparable employee positions. These compensation levels are based on detailed surveys of market compensation levels applicable to each position, and therefore represent a market-based level of compensation. (IAWC Initial Brief at 63) The overhead cost data utilized for each position is also the same as that incurred by the Service Company in connection with comparable employee positions.

According to IAWC, to self-provide all services provided by the Service Company, IAWC would be required to retain 182.5 additional employees (on a full time employee ("FTE") basis), and also would incur increased one-time costs for (1) the hiring of new employees; (2) training and orientation; and (3) relocation cost. (IAWC Ex. 1.00 at 19) The increased cost (including applicable overheads) for all services, including corporate governance, customer service and the employee benefits service center, would amount to approximately $6.25 million. (IAWC Initial Brief at 64)

Accordingly to Ms. Teasley, certain services cannot be feasibly outsourced to non-affiliates. (IAWC Ex. 1.00 at 16) These services include: (1) corporate governance, due to the need to ensure appropriate accountability and to protect the confidentiality of certain information in accordance with securities laws; (2) customer service functions, to assure proper management of customer communication and the billing process, as well as compliance with applicable regulatory requirements; and (3) the employee benefits service center, due to the complex and confidential nature of employee benefits and need to maintain an appropriate relationship between IAWC and its employees. For these functions, IAWC avers, the Self Provision Study shows that use of the Service Company approach, which allows IAWC to “share” the cost of the functions with other American Water operating companies rather than retaining all required employees on its own, results in a significant level of savings for Illinois ratepayers. For the Governance, customer service and employee benefits service center functions, the savings are approximately $1.7 million. (IAWC Initial Brief at 64)

IAWC next addresses the “Resources and Benefits of the Service Company.” IAWC claims the Service Company benefits IAWC by maintaining an organization whose officers and employees are familiar with all facets of the water utility business and are knowledgeable and experienced in the efficient management, financing, accounting and operation of water utility assets and the particular business of IAWC. (IAWC Initial Brief at 64-65) The primary areas of service provided to IAWC by the Service Company are:

- Communications and External Affairs. Providing comprehensive coordination, standardization and support for information sharing within IAWC and externally with governmental agencies and customers. (IAWC Ex. 12.00 at 3)
- Corporate Finance. Providing coordination with IAWC employees, and support for rate activities, budget preparation and analysis, and other regulatory and financial analysis as requested by the management of IAWC. (IAWC Ex. 12.00 at 3-4)
- Customer Service. Providing call center operations, education and training of new employees, quality control, centralized billing, collection activities, and other support functions. (IAWC Ex. 12.00 at 5-8)

- Divisional Operations Support and Regulated Operations. Providing support for IAWC customer relations, such as bill and service order reviews, and engineering related services. (IAWC Ex. 12.00 at 8-9)
- Human Resources. Providing support for management of employees throughout their tenure with IAWC, and handling areas of compensation and benefits, employee and labor relations, HR systems and processes, business center and corporate staffing, and organizational and talent development. (IAWC Ex. 12.00 at 9-12)
- Information Technology Services. Providing support under six divisions: Enterprise Architecture, Security Architecture, Infrastructure and Operations, Business Application Development, Client Services and Support, and the Project Management Office. (IAWC Ex. 12.00 at 12-14)
- Legal. Providing legal support for many IAWC functions, including corporate governance functions and decisions regarding hiring and management of specialized outside counsel. (IAWC Ex. 12.00 at 15-16)
- Operations Services. Providing technical, operations and business professional services in the areas of: engineering, maintenance & supervisory control and data acquisition services, innovation and environmental stewardship, central laboratory services, supply chain, best operating practices, operational risk management. (IAWC Ex. 12.00 at 16-24)
- Shared Services. Providing services in the areas of business development, regulatory programs, internal audits, and investor relations. (IAWC Ex. 12.00 at 25)

According to IAWC, these services are of a high quality and save IAWC the need of replicating them in-house, and no witness in this proceeding has questioned IAWC's need for such services. (IAWC Initial Brief at 64)

Regarding cost allocations, the Service Company performs services for American Water affiliates nationwide. Certain services are provided for the benefit of individual affiliates, while other services provide common benefit to all or a group of affiliates. (IAWC Ex. 5.00 (Rev.) at 4) Records are maintained by Service Company employees, who complete weekly electronic time sheets, showing the time spent by the employee. The employees also identify the affiliate for which the service or activity was performed, whether the affiliate is a regulated or non-regulated affiliate, and whether the work was performed for the benefit of a single or multiple affiliates. (IAWC Initial Brief at 66)

Where possible, the Service Company employee identifies the specific affiliate that a service benefits, so that the cost of that service may be charged to that specific affiliate directly ("Direct Charge"). Where the work benefits multiple affiliates, the Service Company has established a system of allocating costs between the various served affiliates. (Id.) Where services benefit both regulated and non-regulated entities, the costs for services to the non-regulated entities are allocated to them based on Tier 1 formulas. The Tier 1 formulas are based on cost causative factors and reflect the costs of the services provided to the non-regulated entities, with the balance allocated to the benefited regulated affiliates as a group. (IAWC Initial Brief at 66) Common costs that benefit regulated affiliates are allocated in direct proportion to each affiliate's customer count, in accord with the Service Company Agreement. This allocation is referred to as the Tier 2 allocation.

Overhead costs are allocated by the Service Company based on two broad categories: labor benefits (i.e. employee benefits costs such as payroll taxes, medical coverage, pensions, and disability insurance) and general building overhead (i.e. office rent equipment leases, telephone expenses, electricity charges, office supply costs, property taxes, and office maintenance costs). These expenses are allocated in proportion to the labor costs assessed to each affiliate (either under Direct Charge, or Tier 1 and Tier 2 formulas). For regulated affiliates, this allocation methodology is in accord with their respective agreements. (IAWC Ex. 5.00 (Rev.) at 7)

As stated above, the Company's requested level of management fee expense reflects the cost of the services IAWC is projected to receive from the Service Company in the test year. As shown on IAWC Exhibit 5.01R2, the Service Company prepares a detailed budget, which includes details not only by account but also by functional group.

The budget process evaluates the operating needs of the Service Company and the level of costs needed to meet the service expectations of IAWC, as well as other American Water affiliates who use the services of the Service Company. (IAWC Ex. 5.00SR at 10) This evaluation includes a review of employee levels, the benefits for the employees, contract services, rents, transportation costs, travel costs, building costs, depreciation, capital needs and other miscellaneous operating costs. According to IAWC, no witness has challenged any specific aspect of this detailed budget, or any specific aspect of IAWC's Service Company fees.

In addition, Schedules 1, 2, 3, 4, and 5 to the Service Company Cost Study provide detailed descriptions of the projected hours and hourly rates for services to be provided by the Service Company to IAWC in the test year, for each functional area of the Service Company, as well as comparisons to market rates. (IAWC Ex. 11.01) IAWC asserts that no witness challenged the detail forecast data presented in these schedules. (IAWC Initial Brief at 67-68)

Regarding cost controls, Ms. Teasley testified that IAWC takes affirmative steps to both monitor and control the costs incurred by IAWC from the Service Company. IAWC reserves the right to review and approve Service Company budgets before they take effect. It also conducts detailed reviews of Service Company bills and cost allocations under the formulas described by Mr. Grubb, including monthly comparisons of budgeted costs with bottom line actual costs. IAWC uses this information to conduct internal reviews aimed at identifying "areas for further focus" and to make adjustments in a "continuous improvement approach to cost control." (IAWC Ex. 1.00 at 22)

Other efforts of IAWC cost control include a reliability-centered maintenance program, and strategic sourcing of supply needs. By consolidating the purchasing needs of the Service Company's operating companies on both a national and regional basis, economies of scale are purportedly achieved which IAWC could not achieve on its own. IAWC also seeks to promote efficiencies through use of a national call center, support from the American Water Laboratory in Belleville, Illinois, and consolidation of services in such areas as human resources, legal, corporate finance, environmental safety, engineering, communications and information technology systems.

IAWC also secures necessary financing through the Service Company, which achieves economies of scale by consolidating the financing requirements of all the operating utilities in the American Water system. In this way, IAWC has access to reliable sources of debt capital at cost effective rates and in a manner that minimizes transactional and management costs. IAWC also utilizes the energy management group within the Service Company to help lock in favorable long-term rates for large consumption locations. In short, IAWC asserts, IAWC and the Service Company expend a great deal of effort on controlling costs and promoting efficiencies. (IAWC Initial Brief at 68)

2. The AG's Position

In Section III.A of its Initial Brief, the AG argues that "the Commission should reject the 22.5% increase in management fees in less than 12 Months." (AG Initial Brief at 19) IAWC has asked the Commission to include in rates $21,167,057 (excluding incentive compensation) that it claims it will pay to its affiliated Service Company in the 2010 test year. (AG brief at 19-20) The AG claims this amount is 22.5% more than the $17.251 million (excluding incentive compensation) it was allowed to include in rates for the test year ending June 30, 2009 in IAWC last rate case, Docket No. 07-0507. (AG/JM Ex. 5.0 at 49) In Docket No. 07-0507 the management fee expense increased $11,681,000, or about 170%, from the $6,843,000 IAWC recovered in management fees in its prior rate case. These cost increases cover management services that are not provided by IAWC personnel who actually operate the utility on a day-to-day basis. (Tr. 95)

In Section III.A.1, the AG argues, "The Commission should not allow IAWC to recover expenses for both an increased number of IAWC employees and an increased management fee expense." (AG Initial Brief at 20) In its last rate case, the AG asserts, the Commission accepted IAWC's argument that the increase in management fees was justified by "an organizational restructuring in 2004 that ultimately eliminated 31 positions from the payroll of IAWC." (Docket No. 07-0507, Order at 30) However, in this docket, IAWC's payroll shows a consistent increase since February, 2007, after which the actual number of employees rose from 435 to 486 in December, 2008, IAWC Sch. C-11.2a, and the number of authorized employees rose from 446 to 473. (IAWC

Sch. C-11.2b) In the 2010 test year IAWC is asking the Commission to further increase the number of IAWC direct employees to 510. (Tr. at 75-76, 78-79) In addition, the payroll expense and the costs of employee benefits are also increasing. (IAWC Sch. C-11.3 and G-10) Unlike the situation in Docket No. 07-0507 where there was a decrease in IAWC employees, in this docket IAWC claims both an increase in direct employees and a 22.5% increase in the Service Company expense. To the AG, it does not appear that Service Company employees are replacing IAWC employees or are performing work otherwise performed by IAWC employees. (AG Initial Brief at 20)

In testimony, IAWC witnesses produced extensive lists of services provided by the Service Company. IAWC direct employees, however, handle the actual operation of the utility. IAWC President Karla Teasley testified that:

> Illinois-American Water employees are directly involved in the day-to-day operations . . . they provide support in the distribution operations area, in the production area. They are in the field providing day-to-day contact and service to customers every day. . . . the people that run the plants, the people that fix the main breaks, the people that read the meters, the people that provide, you know, some maintenance to the facilities, all of the kind of hands-on day-to-day work that we do to keep the water flowing is provided by Illinois-American Water employees. (Tr. at 95-96)

Ms. Teasley also testified that there are IAWC employees who are responsible for engineering, planning, design, overseeing construction projects and overseeing the capital program, as well as finance and communications and external affairs. (Tr. at 96-97) Yet, the AG complains, IAWC seeks to include in rates more than $20 million for its Service Company to provide management and business services.

The Service Company expense would have been even higher except for amounts for customer accounting and miscellaneous expenses are now accounted for under those expenses that were previously budgeted as service company fees. (AG Initial Brief at 21, citing Tr. at 435) Although Mr. Kerckhove's exhibit 6.02 Supp. shows that as of the filing of IAWC Exhibit 6.00 Supp., IAWC added $821,952 to Customer Accounting and $22,717 to Miscellaneous. If these expenses had not been moved from the Service Company charge, the $544,823 Supplemental increase to the Service Company expense would have been $1,389,492.

In Section III.A.2 of its Initial Brief, the AG argues, "The excessive and repeated increases in the Service Company expense demonstrate that IAWC and the Service Company have failed to exercise fiscal discipline." (AG Initial Brief at 22) The AG says the following table, taken from IAWC Schedule G-1, shows the actual, the planned (or budgeted), and the December 31, 2010 test year level of Management Fees, also known as Service Company or Business Support Services:

Table 1 - Service Company Costs

	Actual	Change from Prior Year	Plan (or Budget)	Change from Prior Year
Dec. 2007	20,093,161		19,278,490	
Dec. 2008	20,248,278	0.77%	19,046,511	(1.2%)
Dec. 2009	n/a		20,121,164	5.6%
Test Yr - Dec. 2010 IAWC Sch. G-5 First Revised, p. 8	n/a		22,560,025	12.1%

For the for 2010 test year, IAWC first budgeted a 9.4% increase from 2009, and a few months later increased its budgeted cost by $544,000, raising the amount requested in rates to 12.1% over the budgeted 2009 amount. In the AG's view, the ultimate increase claimed in the test year is exorbitant compared to the increases/decreases of the prior years, and are even worse when compared to the June 30, 2009 test year amount in Docket No. 07-0507. (AG Initial Brief at 23) When incentive compensation is removed from the June 30, 2009 and the December 31, 2010 test years, the increase from the last case is 22.5%. (AG/JM Ex. 5.0 at 49)

The test year increases, which are so much higher than the Company's actual and planned increases in prior years, coupled with the increase in IAWC employees, demonstrate that IAWC has not been able to realize savings or economies from the use of the Service Company. (IAWC Initial Brief at 23) On page 30 of its Order in Docket No. 07-0507, the Commission stated, in part:

> If IAWC plans to continue to utilize the Service Company because doing so arguably benefits ratepayers by reducing IAWC's labor and other related costs, then at some point the lower costs must be more evident. Based on the evidence, the Commission adopts the management expense as recommended by IAWC. The Commission, however, has a continuing obligation to ensure just and reasonable rates.

In order to ensure just and reasonable rates, the AG argues, the Commission should deny IAWC any increase in the test year Service Company expense. In the AG's view, the Company has not explained why the cost for these services has increased 22.5% compared to the last test year, and has failed to show that this increase is prudent, reasonable, or necessary. The AG finds this increase particularly troubling in light of both the burden consumers are facing due to high unemployment, foreclosures, and the recession; the efforts local governments have made to keep costs low such as layoffs and salary freezes; and the much lower 4.37% increase for the same services between December 2007 and December 2009. A Service Company expense of $17,251,000 (rather than the $21,136,000 requested by the Company) would increase IAWC's operating income by $3,885,000. (AG Initial Brief at 24)

In the alternative, if the Commission will not maintain the Service Company charge at the level allowed in Docket No. 07-0507, AG/JM witness Ralph Smith recommended that the Service Company expense be increased by no more than 5% over the $17.251 million test year expense in Docket No. 07-0507, resulting in an adjustment of $3.022 million to the Service Company expense. (AG/JM Ex. 5.0 at 50) This adjustment removes incentive compensation from both the June 30, 2009 test year and the December 31, 2010 test year, and, in the AG's opinion, is consistent with the growth of this expense reported in IAWC Schedule G-1 and in the table above.

Section III.A.3 of the AG's Initial Brief is titled, "Other States Have Been Troubled By The Increase in Management Fees Claimed By AWWC's Regulated Operating Companies." (AG Initial Brief at 24-26) The Service Company to which IAWC pays the Service Company (or Management or Business Support Services) fee also provides services to other states. (Tr. at 367) In a recent California-American water rate case, the AG says the California PUC allowed substantial reductions in California-American's Service Company and General Office expenses. In the instant case, Docket No. 09-0319, administrative notice was taken of the California Public Utilities Commission's decisions in regard to California American Water Company, and the decisions were filed on e-Docket on December 10, 2009 as IAWC-AG Admin. Notice Doc 1.

In the California PUC's Final Decision No. 09-07-021, the Commission referred to being "[c]onfronted with 'seemingly endless' increases in administrative costs," and noted that in Cal-Am's last rate case, the CPUC approved a settlement that included an audit of Cal-Am by the Division of Ratepayer Advocate ("DRA"). (IAWC–AG Admin. Notice Doc 1 (Part 1) at 94, 95) The CPUC noted that the DRA made 14 specific proposals to Cal-Am's General Office charge and adopted $3.2 million in adjustments. The specific adjustments, including nine that relate to the Service Company, are summarized on Appendix C to the order, which is found in IAWC-AG Admin. Notice Doc 1, Part 3. In its final order, the CPUC allowed Cal-Am to file a Petition to Modify the Order provided it "fully discloses all non-regulated operations which use any assets or employees included in revenue requirement." On rehearing, Cal-Am satisfied the DRA that some of its allocations were in fact supported, and the DRA agreed to allow $7,454,286 of Service Company allocations into rates. (IAWC–AG Admin. Notice Doc 3) The AG says the other adjustments on Appendix C to the Order were not affected.

In addition to California, the Tennessee Regulatory Authority, in reviewing a Tennessee-American Water Company docket, also addressed the issue of escalating management fees. Although it had ordered an audit of the fees, it found that the audit conducted by the Company-retained expert was not independent and "did not address the primary concerns of the Authority that the costs were the results of prudent management decisions." (In re Tennessee American Water Company, Docket No. 08-00039, Order at 21-22, January 13, 2009) The Tennessee Regulatory Authority ordered Tennessee American to issue an RFP for:

> . . . a comprehensive audit by an independent certified public accountant. The RFP for the audit shall include, but not be limited to, an investigation

> of AWWSC's management performance and decisions . . . and evaluate and attest to the charges allocated to TAWC, including the efficiency of processes and/or functions performed on behalf of TAWC, as well as the accuracy and reasonableness of the allocation factors utilized.

According to the AG, these orders, by sister PUCs, demonstrate that the problem with escalating Service Company charges is not unique to Illinois. Although the Commission in IAWC's last rate case did order a study of Service Company costs, the study produced (like in Tennessee) was not independent and does not provide the Commission or the public with any ways to restrain the growth of these charges. In addition to disallowing Service Company charge increases, which provides the appropriate incentive to IAWC to control that cost, the AG suggests the Commission "may wish" to order that an independent audit of AWWSC fees to IAWC be conducted, under the direction of the Commission Staff or the Office of the Attorney General. (AG Initial Brief at 26)

The next sub-section of Section III.A of the AG's Initial Brief is titled, "The Record Shows Poor Service Company Services and Unwarranted Costs." (AG Initial Brief at 26-28) In response to an AG data request, IAWC identified several instances where IAWC challenged Service Company charges and/or practices. As these examples show, the layers of management provided by the Service Company can add unwarranted costs and complexity to address a specific problem. Four examples are:

AG Cross Exhibits 8 and 9: Service Company engineering did not keep IAWC apprised of plans for Illinois plant. IAWC Director of Engineering Jeffrey Kaiser contacted the Service Company on June 3, 2008, shortly after he was hired by IAWC because neither he nor the Illinois head of production were informed of an RFP for an Illinois project. The response, almost two months later (July 29, 2008), finally provides a draft scope of work for Illinois review, and schedules a meeting for the end of August for Service Company people to come to Illinois. As shown in AG Cross Exhibit 9, Mr. Kaiser appropriately objected to paying for travel for six Service Company people to spend four days in Illinois, and the number of Service Company representatives was cut to "three or four at the most."

AG Cross Exhibit 10: The Service Company charged fees to a closed Champaign District project. It was unclear why the charges were posted to the closed project. The e-mail says that "they are not Illinois engineers, and do not report to anyone in our office . . . . Of the eight names, Brent O'Neil did not even recognize at least three of them."

AG Cross Exhibit 12: In July, 2008, Cheryl Norton, hired by IAWC on December 31, 2007, expressed concern that a project that had been ordered more than 14 months earlier was "very complex" and "very costly." She noted that IAWC personnel "had not participated in creating the business requirements" and that the scope of the project was much larger than Illinois needed. Ms. Norton had to protest the allocation of costs to Illinois, saying:

> I don't have a problem paying for Illinois' portion of this, however, there was a substantial amount of time spent creating this for the enterprise and then removing those references. I find it very difficult absorbing the entire amount when this project never should have been so unrealistic. We depend on your department to be the experts and create workable solutions for our regulatory requirements. The original project was so far out of scope that it never should have been developed or considered."

Customer Service Outages, Summer 2008: Ms. Norton also complained to the Service Company about problems with the customer service function. She testified that there were at least two telephone service outages in the summer of 2008, during which customers could not get through to the Company's customer service line. (Tr. at 246) She sent an e-mail saying that "this seems to be happening more and more frequently. That may not be the case, but I know it has happened numerous times in the past few months." (Tr. at 248) Notwithstanding these problems, IAWC was not given a credit or rebate from the Service Company as compensation for poor service. (Tr. at 247)

According to the AG, these examples show that the Commission cannot allow IAWC to include an inflated Service Company expense in rates. Close review to protect consumers from inappropriate services and costs, and limiting the amount that can be included in rates, will provide IAWC with the appropriate incentive to keep these costs from spiraling out of control. The AG says the Commission and IAWC should heed the statement by the Hewitt U.S. Salary Increase Survey, Survey Findings: 2009 and 2010 at page vii: "2010 will not be a year with loose purse strings." (AG Initial Brief at 28, citing AG/JM Ex. 5.0 at 50)

The final subsection of Section III.A of the AG's Initial Brief is titled, "The Lack of Allocation of Management Fees to the Chicago Waste Water District Calls Into Question The Accuracy of The Management Fee and Its Allocation." (AG Initial Brief at 28-29)

In reviewing the Service Company charges, AG/JM witness Ralph Smith noted that there was no allocation of these charges to the Chicago Wastewater District. (AG/JM Ex. 1.0 at 50) Neither IAWC President Karla Teasley nor Paul Herbert, who prepared the cost of service studies, was able to explain the absence of an allocation. Although Ms. Teasley later attempted to suggest that applying Service Company costs to wastewater would somehow result in "double-counting" for customers who take both water and wastewater services, Tr. at 175-175, that argument should be discounted in light of her statements on pages 130-132 about the use of the Service Company services for wastewater customer service, billing, IT, and planning. In connection with planning, Ms. Teasley testified that "some of the greatest challenges" are in the wastewater area. (Tr. at 131)

In the AG's view, the lack of allocation to wastewater calls into question the accuracy of the Service Company allocations in general. Clearly there are services that wastewater customers require that are provided through the Service Company, but those costs are not being correctly allocated to that district. In light of IAWC's high wastewater treatment costs, the AG asserts, one may suspect that this lack of allocation was done to try to limit the size of those costs, albeit to the detriment of water customers. (AG Initial Brief at 29)

In the AG's Reply Brief, Section III.G, the AG further argues that IAWC has failed to justify the escalating management fees it seeks. (AG Reply Brief at 23-27) A mere listing of categories of business needs does not justify the level of costs IAWC seeks to charge ratepayers, in the AG's view. (AG Reply Brief at 26) IAWC asserts that no witness has questioned the need for these services. But in the AG's opinion, the "need" for these categories of service is not the question. The question is: are the cost levels and the repeated, substantial escalation of these cost levels over the last several rate cases reasonable and prudent. The AG also contends that IAWC's "detailed budget" does not provide anything other than a break-out of cost categories.

In Section III.B.10 of the AG's Reply Brief, the AG argues that Mr. Smith did not "arbitrarily" reduce the Management Fee. He testified that a 5% increase was "perhaps somewhat overly generous" in light of low salary increases since IAWC's last rate case and low inflation. (AG/JM Ex. 5.0 at 50-51) In addition, the AG asserts, the 5% figure is consistent with the actual fluctuation in Management Fees between rate cases shown on IAWC Sch. G-1 (Comparison of Prior Forecasts to Actual Data, line 14). (AG Reply Brief at 27)

3. Homer Glen's Position

As noted above, in its Order in Docket No. 07-0507, on pages 30-31, the Commission stated:

> Because the Commission questions whether IWAC is doing everything possible to ensure low costs for ratepayers, the Commission directs IAWC to conduct a study comparing the cost of each service obtained from the Service Company to the costs of such services had they been obtained through competitive bidding on the open market. As part of the study, IAWC must also provide an analysis of the services provided by the Service Company to all of IAWC's affiliates. The analysis must provide details on the specific services provided to IAWC and how costs are allocated among affiliates of IAWC. IAWC shall include the study in its next rate filing.

In Section V of its Initial Brief, Homer Glen et al. argue that the Service Company Cost study submitted in this docket falls far short of the requirements set out in the Final Order. (Homer Glen Initial Brief at 13-14) IAWC divided the study into two parts. The first is a "Self Provision Study" that takes certain items and compares "costs" incurred by other entities, presumably for the same function. According to Homer Glen, a "cost comparison" is not the same as a study that seeks competitive bids for the tasks. Thus by definition, the Self Provision Study fails to comply with the Commission's Order. The second part of the study was a "Market Analysis."

Under this "study," Homer Glen asserts, the Company did a salary survey and applied it to the Company. IAWC's witness Mr. Uffelman, who performed this portion of the study, testified that he did not know how much of the $22 million of the total management charge he looked at. "I have the total company amount which is on Exhibit 5, but I do not have the work papers that show the amount that was included in the study, without doing some calculations." (Tr. at 368-369) Mr. Uffelman asked IAWC to roll all individual costs into an hourly rate for his comparison. (Tr. at 374) He did not know whether or not this is the way IAWC is charged by the management company. "I don't know if that's charged directly or not." (Tr. at 374) He took the total number of hours for engineering, accounting, information technology, legal, and management provided by the Company as well as the costs computed by the Company and asked the Company "to assign the hours to the costs." (Tr. at 375)

He then assumed that the same number of hours would be necessary for a third party to provide the service. In Homer Glen's view, he did not compare the Company results with a bidding process as was ordered in Docket No. 07-0507. Instead, he did a salary survey and turned the information over to "the service company that did the work" to compare whether its costs were higher or lower than the market survey. (Tr. at 377) According to Homer Glen, this approach is hardly an objective way "to conduct a study comparing the cost of each service obtained from the Service Company to the costs of such services had they been obtained through competitive bidding on the open market" as ordered by the Commission. (Homer Glen Initial Brief at 14)

In Section V.C of its Initial Brief, Homer Glen argues that since the Commission questioned the $17.251 million service company fee in the previous docket, it would be inappropriate to include the unsupported $21.136 million request in this docket. (Homer Glen Initial Brief at 14) According to Homer Glen, while the Illinois Attorney General and Joint Municipalities witness Ralph Smith recommends that the affiliated management fee increase be limited to 5 percent over the $17.251 million in the last case, this is a generous number since the "base" $17.251 million was "questioned" in Docket No. 07-0507, giving rise to the Final Order requirement for IAWC to perform the competitive bidding study, which it failed to do for this docket.

Homer Glen also argues that the Commission should order the Company to participate in an independent third-party study conducted under the guidance of the Illinois Attorney General into the operations, billing practices, and other functions conducted by the American Water Works Services Company, Inc. ("Service Company" or "AWWSC"). All costs for the new independent study should be borne by the stockholders of IAWC, and no costs of the study should be paid by ratepayers. (Homer Glen Initial Brief at 13)

In Section III of its Reply Brief, Homer Glen argues, "IAWC's high costs demonstrate that using the Service Company results in no benefits to ratepayers."

(Homer Glen Reply Brief at 6-9) Homer Glen asserts that “IAWC has no control over Service Company’s budget or charges.” Homer Glen further argues that IAWC has not demonstrated that the level of the fee paid to the Service Company is reasonable and necessary.

4. Bolingbrook's Position

Based on the Commission’s directive in its Order in Docket No. 07-0507, Bolingbrook argues, IAWC was to prepare a Service Company Cost Study based on “competitive bidding in the open market.” In Bolingbrook’s view, IAWC has failed to prepare such a study in this proceeding. (Bolingbrook Initial Brief at 5) Rather, IAWC has prepared a “comparative study of Service Company cost and market prices for certain services.” Clearly, a comparative study of market prices is not the same as competitive bidding in the open market. Because the Commission’s Order clearly and unequivocally requires the Service Company study to be based on competitively bid prices, Bolingbrook asserts, IAWC had no discretion to employ any other type of methodology for the study.

As brought out during the testimony in this matter, the Commission’s concerns that led to the Order in Docket No. 07-0507 were justified in Bolingbrook’s view. As Ms. Teasley testified, and as can be ascertained from examining IAWC Schedules G-1 and G-5, the Service Company costs, referred to on line 14 of the schedules as “management fees” (Tr. at 122), show that, from December 2007 to December 2009, IAWC experienced an increase in Service Company fees of 4.37%, including a decrease from December 2008 to December 2009. (Tr. at 124) However, from December 2009 to December 2010, IAWC initially projected an increase in Service Company fees of 9.4%. (Tr. at 124-25) In supplemental testimony, the increase jumped from 9.4% to 12.1%. (Tr. at 125-26) Ms. Teasley blamed this increase on the “economy” and other vague, unspecified factors. (Tr. at 127) Accordingly to Bolingbrook, Ms. Teasley’s statements that the economy somehow justified such a large, one-year increase from the Service Company fall flat. (Bolingbrook Initial Brief at 7)

Bolingbrook argues that the methodology of the Service Company Cost Study does not include even one competitively bid service. (Bolingbrook Initial Brief at 7) The Service Company Cost Study submitted by IAWC consists of two general components: the “Self Provision Study” (IAWC Ex. 1.04) and the “Market Analysis.”

Bolingbrook asserts that the Self Provision Study (IAWC Ex. 1.04) attempts to analyze the reasonableness of Customer Accounts costs (the “Customer Accounts Analysis”) based on a utility “cost comparison” methodology, not a competitive bidding methodology, as required by the Commissioner’s Order. (Bolingbrook Initial Brief at 8)

The Self Provision Study not only failed to comply with this Commission’s Order, but was also inherently flawed, in Bolingbrook’s view. Karla Teasley, President of IAWC, testified that the purpose of the Self Provision Study was to analyze whether, if the service company was not performing those functions, what specific positions and how many positions would be needed at IAWC. (Tr. at 111-12) For purposes of the Self Provision Study, it was assumed the IAWC employees would need the same number of hours to complete tasks as those from the Service Company (Tr. at 113-14), that IAWC would pay its employees the same amount as what the Service Company pays its employees (Tr. at 114-15), and that IAWC would have the same overhead costs as those of the Service Company (Tr. at 115).

Even though all of these numbers were assumed to be the same, the Self Provision Study somehow concludes that IAWC would need more employees than the Service Company to complete the tasks. (Tr. at 115) Ms. Teasley asserted that "economies of scale" explained the difference. (Tr. at 115-16) Bolingbrook argues that this assertion is wrong, because the Self Provision Study assumed that the costs were equal. (Tr. at 113-15; Bolingbrook Initial Brief at 8-9)

Regardless, Bolingbrook argues, the second part of the Service Company Cost Study deals with "market cost" comparisons of various services provided by the Service Company, and is not based upon competitively bid prices, either. (Bolingbrook Initial Brief at 9-10)

Further, Bolingbrook argues, the Service Company Cost Study is inherently flawed. Mr. Uffelman, who performed the salary portion of the study for IAWC, testified that he merely took the number of hours for engineering, accounting, information technology, legal and management services from IAWC (without questioning the same), as well as the costs computed by IAWC, and asked IAWC to "assign the hours to the costs." (Tr. at 375) He then assumed that the same number of hours would be necessary for a third party to provide the service. (Tr. at 375-76; Bolingbrook Initial Brief at 10)

In Bolingbrook's view, because the presentation of a competitively bid cost study for services was required as an express condition of IAWC's "next rate proceeding," the present rate proceeding should be dismissed in its entirety by the Commission due to the lack of the mandated study. (Bolingbrook Initial Brief at 10)

Alternatively, Bolingbrook contends, because IAWC's failure to comply with the Commission's Order in Docket No. 07-0507 relates to its purported costs from its Service Company, IAWC should be prohibited from asserting, in this rate proceeding, that its purported costs from its Service Company are any different from those which the Commission found to be the costs from the Service Company in Docket No. 07-0507. (Bolingbrook Initial Brief at 10)

5. IAWC's Response to Other Parties

In Section III.B.10.a of its Reply Brief, IAWC asserts that its evidence in this proceeding fully meets the requirements of the Commission's Order in Docket No. 07-0507. (IAWC Reply Brief at 37-47) According to IAWC, the Docket No. 07-0507

Order does not require use of a particular methodology to project market prices, and does not require that IAWC conduct a bid process. Furthermore, the methodology used in the SCCS to project 2010 market prices was not criticized in the testimony of any witness in this proceeding. (IAWC Reply Brief at 38)

Without the benefit of evidence, IAWC asserts, AG, Bolingbrook and the Municipalities maintain that IAWC should, at the time of the SCCS, have conducted a procedure to obtain competitive bids as a basis to project market prices for services expected to be required during 2010. (IAWC Reply Brief at 41) IAWC's consultant, Deloitte & Touche, utilized data from two types of sources. First, Deloitte & Touche used widely utilized surveys of market prices, as well as supplemental data, to arrive at expected 2010 hourly prices as would be obtained through competitive bidding. As with all other aspects of the SCCS, IAWC argues, no witness challenged use in the SCCS of this approach, or suggested that, at the time of the SCCS, some other approach was feasible. (IAWC Reply Brief at 43)

IAWC further asserts that without the benefit of evidence, AG, Bolingbrook and the Municipalities maintain in their Initial Briefs that, to project 2010 market prices, IAWC should also have sought bids for expected 2010 services. The SCCS, however, was prepared over a period of several months prior to the filing of this proceeding on May 29, 2009 (Tr. At 363), and the Docket No. 07-0507 Order did not require the issuance of RFPs in that time frame to project market prices. IAWC interpreted the Order as requiring a comparison of projected Service Company costs to the expected cost of services "had they been obtained through competitive bidding on the open market," and IAWC presented this comparison through the SCCS for services that can be obtained from affiliate or non-affiliate and the Self Provision Study for other services. (IAWC Reply Brief at 43)

In suggesting the Docket No. 07-0507 Order contemplated a bid requirement, IAWC argues, the AG, Bolingbrook and the Municipalities simply disregard the Docket No. 07-0507 Order's actual language. Further, these parties assume in their Initial Briefs, without the benefit of evidentiary support, that to project 2010 service pricing, the issuance of RFPs to prospective suppliers during the SCCS timeframe would have been feasible. No witness testifying for the AG, Bolingbrook or the Municipalities (or any other party) suggested that such a procedure could feasibly be employed, or that such an approach would produce projected 2010 pricing information more accurate than that produced by the projection method that Deloitte & Touche employed. Indeed, IAWC contends, no witness criticized the SCCS's methodology or its results in any way. In addition, no witness suggested that information received in that time frame would provide a better indicator of actual 2010 pricing than did the extensive survey information and Supplemental Data utilized in the SCCS.

In IAWC's view, the statements of AG, Bolingbrook and the Municipalities on this point amount to no more than speculation of counsel that some procedure or methodology for the SCCS other than that utilized by Deloitte & Touche would have been preferable. The Commission, however, must base its decision on the evidentiary record. (IAWC Reply Brief at 43-44, citing 220 ILCS 5/10-103)

In their Initial Briefs, AG and the Municipalities also criticize various aspects of the Company's test year projections of Service Company hours and costs. According to IAWC, no witness in this case criticized the approach used in the SCCS for the purpose of projecting Service Company hourly costs or for adjustment of Service Company hourly costs for purposes of providing the required comparisons. (IAWC Reply Brief at 44-45)

The AG and Municipalities also assert that the projection of 2010 hourly costs was not adequately explained. Each aspect of the 2010 hourly cost projection is explained in the SCCS (IAWC Ex. 11.01) at pages 5 to 18. The 2010 cost projection is provided in Schedules in the SCCS that are supported by the testimony of Mr. John Young. IAWC asserts that no witness in this case criticized the SCCS' methodologies used to project either Service Company 2010 hourly cost or 2010 market prices. (IAWC Reply Brief at 45-46)

According to IAWC, no witness identified even one service area or job classification for which, in the opinion of the witness, the number of hours forecasted in the projection was unreasonably high. IAWC also notes that the work performed by the Service Company performs work at cost (with no profit component). (IAWC Reply Brief at 46)

In their briefs, the AG, Municipalities and Bolingbrook assert that IAWC's Management fees are "excessive" (AG Initial Brief at 22) and that "IAWC has failed to control its costs" owed to the Service Company (Bolingbrook Initial Brief at 3), and has "failed to exercise fiscal discipline." (AG Initial Brief at 22) According to IAWC, no witness challenged the detailed forecast data presented in the IAWC schedules for any classification, and no witness criticized IAWC's service procurement policies. (IAWC Reply Brief at 47-48)

With regard to the AG's reference to e-mails in which IAWC raised concerns about Service Company charges or services, IAWC asserts that these items provide support for Ms. Teasley's testimony regarding IAWC's efforts to monitor and review Service Company billing and performance. (IAWC Reply Brief at 48-49)

IAWC claims it also provided detailed evidence as to why the level of test year management fees has increased over the amount allowed in the prior case and over prior years. Mr. Grubb provided information addressing a number of factors that resulted in increased Service Company costs, including: increased pension and OPEB costs, increased depreciation expenses, caused by capital investments, increased maintenance costs for information technology systems, and increases in labor and group insurance costs. (IAWC Reply Brief at 50)

In Section III.B.10.c of its Reply Brief, IAWC disputes the AG's recommendation that the Commission deny any increase in management fees. (IAWC Reply Brief at 52) According to IAWC, the AG's recommendation was not made by any witness in this proceeding, is unsupported by the record; and disregards the testimony of the AG's own witness, Mr. Smith, who recommends that IAWC's level of management fees be increased by 5%. IAWC also argues that Mr. Smith's 5% recommendation is an arbitrary limit that is not based on any specific analysis of IAWC's management fees, and ignores increases in Service Company costs that are demonstrated by the evidence.

In Section III.B.10.d of its Reply Brief, IAWC opposes the AG's and Municipalities' recommendation that the Commission order, or consider ordering, an independent audit of the Service Company's fees. Given the extensive opportunity in this case for parties to review and examine information regarding the services IAWC receives from the Service Company, IAWC finds it difficult to imagine what benefit there would be in ordering yet another study to develop the very same types of information presented in this case. (IAWC Reply Brief at 54) Moreover, IAWC argues, the Municipalities' suggestion that the cost of this unnecessary study be borne by the utility is not consistent with the requirements of the Public Utilities Act. The cost of independent audits or investigations, moreover, "shall be recovered as an expense through normal ratemaking procedures." (IAWC Reply Brief at 55, citing 220 ILCS 5/8-102)

In Section III.C.10.e of its Reply Brief, IAWC argues that its hiring of additional employees does not support a finding that management fees are unreasonable. Among other things, Ms. Norton testified that to improve overall customer service and business performance, IAWC initiated a process to increase the state-level focus of its management structure. (IAWC Reply Brief at 55-56)

In Section III.C.10.f of its Reply Brief, IAWC argues that the AG's references to proceedings in other jurisdictions should be disregarded. There is no testimony regarding the similarity of conditions of operations, service area characteristics, types of service provided, number of customers, the nature and extent of Service Company services provided or other elements of comparability between IAWC and either Tenn-Am or Cal-Am.

Absent a showing of comparability between IAWC and either Cal-Am or Tenn-Am, IAWC argues, there is no basis for relying on either the California or Tennessee Order to support any specific claim regarding IAWC's proposed rate increase. (IAWC Reply Brief at 57, citing Antioch Milling Co. v. Public Service Co. of Northern Illinois, 4 Ill. 2d 200, 210 (Ill. 1954) (excluding evidence of differing rates where party failed to demonstrate that the utilities being compared were sufficiently similar to warrant comparison) Moreover, IAWC states, the California Proceeding is still pending. (IAWC Reply Brief at 58)

6. Commission Conclusion

IAWC uses its affiliated Service Company to provide numerous services. The terms related to IAWC's use of and charges for services provided by the Service Company are set out in the Services Company Agreement previously approved by the Commission. Under the Service Company Agreement, the Service Company provides services for IAWC at the Service Company's cost, i.e., with no profit component.

The Company's requested level of expense in this docket, $21.167 million excluding incentive compensation, reflects the cost of the services IAWC is projected to receive from the Service Company in the 2010 test year.

In its Order in IAWC's last rate case in Docket No. 07-0507, the Commission stated on pages 30-31:

> Because the Commission questions whether IWAC is doing everything possible to ensure low costs for ratepayers, the Commission directs IAWC to conduct a study comparing the cost of each service obtained from the Service Company to the costs of such services had they been obtained through competitive bidding on the open market. As part of the study, IAWC must also provide an analysis of the services provided by the Service Company to all of IAWC's affiliates. The analysis must provide details on the specific services provided to IAWC and how costs are allocated among affiliates of IAWC. IAWC shall include the study in its next rate filing.

As explained in some detail above, IAWC asserts that it met this requirement through a set of studies and the testimony of five witnesses. This evidence purportedly shows that for those services that (1) IAWC obtains from the Service Company; and (2) can be obtained from an affiliate or non-affiliate source, the amount paid by IAWC to the Service Company is well below the cost that IAWC would be required to pay a non-affiliate provider based on market prices for services.

Intervenors AG, Homer Glen et al. (Joint Municipalities) and the Village of Bolingbrook take issue with IAWC's request.

They view the 22.5% increase in the amount allowed in the last rate case, for the test year ending June 30, 2009, as excessive. The AG also states that for the 2010 test year, IAWC first budgeted a 9.4% increase from 2009, and a few months later increased its budgeted cost by approximately $544,000, raising the amount requested in rates to 12.1% over the budgeted 2009 amount.

These Intervenors also assert, through arguments of counsel, that the Company's cost study did not comply with the directive in the Order in Docket No. 07-0507. On this issue, the Commission finds that the studies performed by IAWC represent a reasonable effort to comply with the directive of the Commission. Whether

IAWC's analysis makes the proper cost comparisons contemplated in the Order is not solely a legal question, and references by Municipalities, Bolingbrook and the AG to competitive bidding procedures applicable to municipalities do not make it so. Rather, the issue involves, at least in part, questions of fact, and in that regard the conclusions of those Intervenors are not supported by evidence of record. Further, from a practical standpoint, it is difficult to see how IAWC could have responded in the manner suggested by those Intervenors, and it does not appear that any such arguments by Intervenors were supported by witness testimony.

With respect to the magnitude of the expenses, the AG and Municipalities raise concerns about the level and timing of increases in Service Company fees in the test year. In that regard, AG/JM witness Smith recommended that the fees allowed be limited to 5% over the amount approved in Docket No. 07-0507. According to the AG, the 5% figure is consistent with the actual fluctuation in Management Fees between rate cases.

As explained by the Commission in prior cases (e.g. Docket No. 02-0690), a test year is intended to be a representative period. Where there have been wide fluctuations in an expense item, the amount projected for the test year may not be fully representative of a normal year. Such concerns may be present when, as in the instant case, the forecasted test year expense or degree of increase is considerably higher than prior years, particularly where the test year expense also reflects large increases in the amount originally budgeted, and the expense item is one for which the Commission previously questioned the Company's efforts to ensure low costs.

Based on its review of the record, the Commission believes that the amount initially budgeted by IAWC for the Service Company fees for 2010, before subsequently increasing that amount by approximately $544,000, would be a reasonably representative and normal test year amount for Service Company fees, and is otherwise appropriate for purposes of setting rates in this proceeding.

On this issue, the Commission is not unmindful of continuing concerns over IAWC Service Company expenses. The Commission, however, is ultimately required to base its findings on actual evidence of record. In this case, subject to the adjustment adopted above, the evidence presented supports a finding that the Service Company fees approved in this Order are reasonable and should be included in revenue requirement to be recovered through rates.

As discussed above, Municipalities urge the Commission to order that an independent audit of the Service Company's fees be performed, and that such cost be borne by IAWC with no recovery of it from ratepayers. The AG suggests the Commission may want to consider ordering such an audit.

IAWC opposes such an audit as lacking any incremental benefit. Moreover, IAWC argues, the Municipalities' suggestion that the cost of this study be borne by the utility is inconsistent with language in Section 8-102 of the Public Utilities Act stating such costs “shall be recovered as an expense through normal ratemaking procedures.”

The Commission believes it is possible that an independent audit could be of benefit in evaluating the Service Company fees assessed to IAWC. Whether such an audit would be cost-beneficial, however, is not determinable at this time, as the cost of such an undertaking is unknown. As such, ordering such an audit in this Order would be premature. Therefore, the Commission finds that IAWC should be ordered to file a detailed estimate or estimated range of such costs within 60 days after entry of this order. Other parties shall be given the opportunity to make such a filing if they choose to.

C. Purchased Power and Fuel Expense

1. IIWC's Position

IIWC recommends an adjustment to IAWC’s test-year purchased power and fuel ("PPF") expense and attaches Appendix A intended to support its position. (IIWC brief at 36-39) IIWC states that Illinois-American’s forecasted test-year expense for purchased power and fuel is $7,721,104 on a total Company basis. (IIWC brief at 36, citing IIWC Ex. 2.0 at 12)

Using the forecasted test year total Company sales volume of 49,811,767 CCF, purchased power and fuel expense for the test year is $0.1550 per CCF on a total Company basis. Illinois-American’s purchased power and fuel expense as approved by the Commission in the last rate case was $7,572,299 on a total Company basis, based on a total sales volume of 52,588,940 CCF. Using the sales volumes and level of expense approved in the last rate case, purchased power and fuel expense for Illinois-American on a total company basis was $0.1440 per CCF. Thus, IIWC asserts, Illinois-American is forecasting an increase in purchased power and fuel expense in the test year of approximately 8% on a per CCF basis over the level of expense approved in the Company’s last rate case.

IIWC disagrees with the estimated 8% increase in purchased power and fuel expense for the test year. As a result, IIWC recommends that Illinois-American’s purchased power and fuel expense in the test year be held at the $0.1440 per CCF of sales volume as approved by the Commission in the last rate case.

Illinois-American sets forth two reasons for the 8% increase on a per CCF level to purchased power and fuel expense, first citing an increase in usage requirements. Since the last rate case, the Company states that several new facilities have been placed in service. (Norton, IAWC Ex. 2.00R at 3). The Company alleges that these new facilities have caused an increase in the Company’s total power demand, resulting in an increase in total projected fuel and power expense. Second, the Company anticipates an increase in electric delivery service charges. However, in IIWC’s view, neither reason justifies an overall 8% increase in test year purchased power and fuel expense on a per CCF basis.

According to IIWC, comparing past actual expense to present test-year expense does not support the increase requested by Illinois American. A review of Schedule G-5 from the Part 285 Filing in Illinois-American's last rate case shows the Company had electric power supply contracts for the period of 2007 through 2009. (IIWC Norton Cross Ex. 3) According to Schedule G-5, 80% of the Company's electric usage for the period 2007 through 2009 is under a power supply contract entered into in late 2006 and early 2007 time period. (Norton, IAWC Ex. 2.0R at1-2) In IIWC's view, it is important to note that the per-unit cost of power supply under contract for 80% of Illinois-American's load has decreased for the 2010 test year as compared to the per-unit cost of power supply under contract in 2007 through 2009. Illinois-American recognizes that the new electric power contracts reflect per-unit power supply costs approximately 10% lower than the prior contracts identified in Schedule G-5. Therefore, IIWC asserts, Illinois-American's electric power supply costs for load under contract have decreased significantly since the last rate case.

IIWC further argues that Illinois-American has not justified any increase since the last rate case for the remaining 20% of its electric load not under contract. In fact, the Company agrees that power prices in general have decreased from 2008 to the present. (Norton, IAWC Ex. 2.0R at 3) These decreased power supply costs have not translated into reduced purchased power expenses for the Company in the test year. The Company's per unit cost of power supply for the test year of $0.0719 per kilowatt-hour ("kWh") exceeds the actual per unit cost of power supply for both 2007 ($0.0664 per kWh) and 2008 ($0.0704). (IIWC brief at 37-38)

Next, IIWC claims "Illinois-American's argument that new facilities have increased purchased power and fuel expense for the test year is not justified." (IIWC brief at 38) The Company states that several new facilities have been placed in service since the last rate case. (Norton, IAWC Ex 2.0R at 3). The Company alleges that these new facilities have caused an increase in the Company's total power demand, resulting in an increase in total projected fuel and power expense. However, according to IIWC's calculations, the Company's energy usage per gallon of water delivered to the system for the test year, 2.08 kWh/thousand gallons, has in fact decreased as compared to the energy required to deliver a thousand gallons of water in 2007 (2.20 kWh/thousand gallons) and 2008 (2.17 kWh/thousand gallons).

This decrease in the amount of kWh required to deliver a thousand gallons of water to the system suggests that the Illinois-American system has actually become more efficient electrically. Therefore, in IIWC's view, the addition of the new facilities on the Illinois-American system should contribute to a decrease in the purchased power and fuel expense on a per CCF basis, as compared to the level of purchased power expense approved in the last rate case. (IIWC Initial Brief at 38)

IIWC next argues that projected increases in electric delivery service rates do not justify an 8% increase in power expense. Electric distribution/delivery costs represent approximately 20% of Illinois-American's total electric power costs. (Norton, IAWC Ex. 2.00SR at 3) According to IIWC Norton Cross Exhibit 1, Ms. Norton estimated Illinois-American's electric power distribution costs in 2007 were $1,738,347 and were $1,776,804 for the 2010 test year.

Using Illinois-American numbers, if the Company's total energy usage for 2007 (104,078,275) were divided into the Company's electric distribution costs for 2007 ($1,738,347), it would produce a cost of $0.0167 per kWh. In comparison, if the Company's total energy usage for 2010 (98,265,280) were divided into the Company's electric distribution costs for 2010 ($1,776,804), it would produce a cost of $0.0181 per kWh. This represents an estimated 8.26% increase in per unit ($/kWh) distribution costs for 2010 as compared to 2007. (IIWC Ex. 2.0 at 13)

An 8.26% increase on 20% of Illinois-American's total electric power costs represents a weighted average increase of only 1.65% (8.26% x 20% = 1.65%) in total electric power costs. According to IIWC, the increase in total purchased power and fuel expense attributable to increased distribution costs should not overwhelm the decrease in electric supply costs resulting from lower priced supply contracts in the test year, and the increase in distribution costs/delivery service costs should not result in an overall increase in purchased power expense for the test year. Therefore, in IIWC's view, the projected increase in electric delivery service rates does not justify an overall increase of 8% on a per CCF basis in purchased power and fuel expense for the Company in the test year.

Therefore, IIWC recommends that the purchased power expense for the test year be held at the level approved in the last rate case, $0.1440 per CCF of total sales volume.

2. IAWC's Position

Illinois-American takes issue with IIWC's recommendation. (IAWC Reply Brief at 32-36) IAWC claims IIWC's Initial Brief relies on a series of conflicting and incorrect figures as the basis of its recommendation, and that IIWC also ignores the final projected level of PPF expense recommended by IAWC (IAWC Ex. 6.01SR), which reflects, as discussed below, IAWC's increase in projected test year water sales to U.S. Steel (a revision advocated by IIWC). (IAWC Exs. 6.01SR; 6.02SR) Moreover, IIWC's own analysis of increases related to power distribution (delivery service) costs confirms the reasonableness of IAWC's test year PPF expense projection, in IAWC's view.

Due to the demands of new facilities, increasing delivery charges, and weather conditions which caused depressed demand in the years prior to the test year, PPF expense is projected to increase in the test year. (IAWC Initial Brief at 48-53) IAWC's proposed level of test year PPF expense is $9,039,309. (IAWC Ex. 6.01SR) This reflects an increase in PPF expense related to IAWC's upward revision of its projected test year water sales to U.S. Steel. (IAWC Exs. 5.00SR at 2; 6.01SR) The decrease in the electric supply charges that resulted from IAWC's negotiation of new power contracts for 2010 is partially offset by increased usage requirements and a projected increase in delivery charges. Comparing the Company's actual fuel and power expense data for the period 2007-2009 to the test year in this case shows that the Company's test year fuel and power expense is, on a cost per 1000 gallons of water produced basis, consistent with 2007-2009 levels (and is slightly below 2009). (IAWC Ex. 2.00SR at 2)

In its Initial Brief, IIWC relies on the calculations of Mr. Collins from his direct testimony to develop its recommendation that IAWC's test year PPF expense level be set at $0.144 per CCF of sales. (IIWC Initial; Brief at 36) According to IAWC, the numbers used by Mr. Collins in his direct testimony were incorrect. First, IIWC incorrectly states that the Company's test-year expense for PPF is $7,721,104. (IAWC Reply Brief at 33-34) This figure was incorrect at the time of IIWC's direct testimony (IAWC's proposed update level of PPF expense was $8,839,320), and is incorrect now. IAWC's actual test year projection of PPF expense is $9,039,309. (IAWC Ex. 6.01SR) In addition, as a result of IAWC's revised projection of test year water sales to U.S. Steel (see IAWC Ex. 5.00SR at 2), the level of test year water sales to U.S. Steel would increase to an annualized usage of 1,630,896 CCF. As IAWC's original projection of water sales to U.S. Steel was 500,000 CCF, the new projection would add 1,130,896 CCF in sales to Mr. Collins test year level of water sales of 49,811,767 CCF, for a total of 50,942,663 CCF. This change also increases test year PPF expense by approximately $200,000. IAWC says IIWC's brief further misstates the Company's authorized PPF expense in the prior rate case as $7,572,299; whereas, the actual figure is $8,165,110. (IAWC Reply Brief at 34, citing Docket 07-0507 Order, Appendices A-F)

Furthermore, in IAWC's view, Mr. Collins' PPF expense recommendations contained other flaws. First, his recommendation focuses on power use per CCF of customer sales. Sales, however, provide an incomplete picture of the Company's water production. The Company's water production also includes non-revenue water, which includes unaccounted-for water and water used for other known (non-sales) purposes, in addition to sales. (IAWC Ex. 2.00 at 9) IAWC's witness Ms. Norton, by contrast, considers PPF expense on a total system delivery basis in concluding that IAWC's test year level of PPF expense is reasonable. (IAWC Ex. 2.00SR at 2)

In addition, as explained by Mr. Kerckhove, Mr. Collins calculates fuel and purchased power costs per CCF for Zone 1 and Total Company, and proposes adjustments to Zone 1 and to Total Company, which latter adjustment must be assigned to all rate areas other than Zone 1. (IAWC Ex. 6.00R2 at 16-17) Instead of calculating test year amounts for fuel and purchased power for the Chicago Metro, Pekin, and Lincoln rate areas, Mr. Collins groups them into the result of Total Company less Zone 1 by default. This understates the fuel and purchased power cost per CCF from the prior rate case and overstates the fuel and purchased power adjustment for the total company by $80,221, according to IAWC. Instead, IAWC contends, Mr. Collins should have extended the calculation for each rate area, with the Total Company amount the sum of the individual rate areas. The effect is to erroneously reduce fuel and purchased power costs for the Company by artificially applying a "fallout" rate to all non-Zone 1 rate areas. (IAWC Reply Brief at 34-35)

Appendix A to IIWC's initial brief presents an analysis of IAWC's PPF expense that IIWC claims supports the conclusion that IAWC's projected level of test year PPF expense is unreasonable. According to IAWC, IIWC Appendix A, however, was not prepared by any witness in this proceeding and no witness' testimony supports its reliability or accuracy. No witness testified that the numbers or calculations contained in IIWC Appendix A were accurate or that the methodology employed to develop Appendix A is appropriate. Further, IAWC argues, no witness testified that the conclusions IIWC makes in its Initial Brief based on IIWC Appendix A are valid. (IAWC Reply Brief at 35)

Moreover, IAWC asserts, the conclusion in IIWC's Initial Brief regarding increases in distribution costs, based on the calculations in Appendix A, serve to confirm the reasonableness of IAWC's test year projection of PPF expense. (IAWC Reply Brief at 35) IAWC says IIWC does not appear to dispute IAWC's projected increase in distribution charges in 2009 and the test year, as compared to prior years. In fact, IIWC, relying on IIWC Appendix A, calculates that there has been an estimated 8.26% increase in per-unit distribution costs from 2007 to 2010. As a result, IIWC concludes that, for 2010 as compared to 2007, "[a]n 8.26% increase on 20% of Illinois-American's total electric power costs represents a weighted average increase of only 1.65% (8.26% x 20% = 1.65%) in total electric power costs." (Id.) Applying a 1.65% increase to IAWC's total power costs for 2007 of $8,648,490, as shown on IIWC Appendix A, however, produces a total power cost of $8,791,190. According to IAWC, applying IIWC's logic, and adding the $200,000 for added fuel and power expense related to the projection of increased sales to U.S. Steel, as discussed above, results in a total power cost projection of $8,991,190 for 2010, which is consistent with IAWC's actual projection of test year $9,039,309.

IIWC also suggests that the "addition of the new facilities on the Illinois-American system should contribute to a decrease in the purchase power and fuel expense on a per CCF basis." (IIWC Initial Brief at 39) IAWC says it demonstrated, however, that new facilities would in the aggregate increase power demands and PPF expense. (IAWC Reply Brief at 35-36) For example, IAWC asserts, as indicated in the Company's initial brief, the Champaign district saw electric power costs per million gallons increase by approximately 15% with the introduction of the new facility in that district -- $191.88/MG prior to the new facility being brought online and $224.82/MG afterwards. (IAWC Initial; Brief at 50) According to IAWC, because IIWC's recommendations regarding PPF expense are based on incorrect data or flawed analyses, and IAWC has demonstrated, as explained in its Initial Brief (pp. 48-53), that its projection of test year power cost is reasonable, IIWC's proposed adjustment to calculate PPF at $0.144 per CCF should be rejected.

3. Commission Conclusion

IAWC's proposed level of test year purchased power and fuel expense, contained its surrebuttal testimony, is $9,039,309. IAWC says this value reflects an increase in PPF expense related to IAWC's upward revision of its projected test year water sales to U.S. Steel. IIWC believes that IAWC has overstated the cost of PPF and recommends that the Commission limit the cost of PPF, on a per CCF basis, to $0.144 per CCF, which is the value that was reflected in Docket No. 07-0507.

The Commission understands IIWC's concern in that PPF expense for water and sewer utilities can be significant. The cost of PPF is a function of electric power supply costs, electric delivery costs, and the amount of electricity used. As an initial matter, because IAWC has operating districts throughout Illinois, the cost of electric delivery services will not be identical in each district. Additionally, it does not appear that IIWC has properly considered the amount of electricity used in each district. In fact, it is not entirely clear how the Commission is expected to implement the IIWC proposal for each district based on a cap of $0.144 per CCF. Finally, it also appears that IIWC's proposal to limit IAWC's PPF expense may be at least somewhat inconsistent with its position that IAWC has understated sales to U.S. Steel in the Interurban district of Zone 1. In summary, the Commission is not convinced of the merit in IIWC's proposed method for capping or calculating PPF expense.

The Commission finds IAWC's explanation of its PPF expenses to be more clear and straightforward. It appears that the decrease in electric power supply cost has been offset to some extent by increases in electric delivery service cost and increased electricity usage. In the Commission's view, IAWC Ex. 2.01 SR, which shows actual PPF expense by district, for 2007 through 2009 along with the current projections for the 2010 test year, largely supports IAWC's position. As stated earlier, PPF depends upon electric power supply costs, electric delivery costs, and the amount of electricity used. The Commission also believes this exhibit does not support IIWC's assertion that there is anything unusual about the cost of electricity on a per gallon or CCF basis. To the extent IIWC recommends a reduction in IAWC's proposed PPF expense, the Commission concludes that the record does not support such an adjustment and it will not be adopted.

D. Insurance Other Than Group

1. The AG's Position

In his review of IAWC's filing, AG/JM witness Ralph Smith observed that IAWC had included an increase to its insurance expense for a "Retrospective Adjustment" or "Retrospective Accrual." This $212,660 expense was not included on IAWC Schedule C-17 First Revised for 2007, 2008 or 2009; was not in IAWC's original filing; was not addressed by IAWC in its Direct, Supplemental, or Rebuttal-1 or Rebuttal-2 testimony; and was not in IAWC's last rate case (Docket No. 07-0507). (AG/JM Ex. 5.0 at 45) This adjustment would increase the Insurance Other Than Group ("IOTG") expense to $3,721,452.

In the AG's view, IAWC's attempt to increase its insurance expense to account for the Retrospective Accrual is unreasonable and should be rejected by the Commission. (AG Initial Brief at 30-31) IAWC's actual expense for IOTG has been notably under-budget for each of the years 2007 and 2008 and IAWC has received refunds from its insurers for those years. (AG/JM Ex. 5.0 at 46) For 2007 the insurance over-payment was $2.3 million and in 2008 IAWC's over-projection for IOTG was $0.9 million. In addition to these over-payments, American Water Works Service Company received a retrospective return on its premium in 2008 and in 2007 and it received a cumulative refund for the years 1975-2006. In all, IAWC received insurance refunds totaling $411,900.

According to the AG, in light of the consistent over-budgeting of its insurance expense and the sizable refunds IAWC and its affiliates have received over the past few years, it is unreasonable for IAWC to attempt to increase its insurance expense by $213,000 by adding a "Retrospective Accrual" adjustment.

2. IAWC's Position

In response, IAWC asserts that the Retrospective Accrual amount was not excluded from its original filing; rather, it was included in the Company's original filing under the "Annual Premium" column of Schedule C-17. (IAWC Reply Brief at 37) In IAWC's update filing, the Retrospective Accrual amount was listed separately on Schedule C-17 First Revised for clarity. (IAWC Ex. 7.00R1 Rev. at 3) Moreover, the Retrospective Accrual is a prospective review of expected future insurance claims cost based upon current IOTG premiums for General Liability, Auto Liability, and Workers Compensation, utilizing the most recent available loss information and claims experience, and is a proper test-year expense. This review results in an adjustment to annual IOTG expense that represents insurance costs for current claims in excess of premium costs, and is therefore an appropriate test year cost.

IAWC notes that although Staff initially objected to the inclusion of the Retrospective Accrual as a test-year expense, Staff witness Wilcox withdrew his adjustment related to the Retrospective Accrual. (Staff Ex. 9.0, p. 5)

3. Staff's Position

In direct testimony, Staff witness Wilcox proposed an adjustment to disallow the insurance amount referenced as "Retrospective Adjustment (Commercial General Liab, Auto Liab, and Workers Comp)." The "Retrospective Adjustment" to Insurance Expense was not included in the Company's original filing; it initially appeared in Schedule C-17 First Revised of the Company's response to Staff Data Request LHW 8.01. Mr. Wilcox presumed the Retrospective Adjustment was based on costs incurred during previous accounting periods, and, as such, was not appropriate for inclusion as a test-year expense. (Staff Exhibit 2.0 at 4)

In rebuttal testimony, Company witness Bernsen testified that "Retrospective Adjustment" as used on Schedule C-17 First Revised was a misnomer, indicating that the correct term for the line item was "Retrospective Accrual." Mr. Bernsen testified that the Retrospective Accrual is a prospective review of expected future insurance claims cost based upon current IOTG premiums for General Liability, Auto Liability, and Workers Compensation, utilizing the most recent available loss information and claims experience. This review results in an adjustment to annual IOTG expense that represents insurance costs for current claims in excess of premium costs. For the test year, IAWC projected that a Retrospective Accrual adjustment, representing an additional expense above projected IOTG premiums, would be required. (IAWC Ex. 7.00R1 Rev. at 2-3)

Mr. Wilcox, in rebuttal testimony, accepted Mr. Bernsen's explanation and withdrew the adjustment. (Staff Initial Brief at 15-16; Staff Exhibit 9.0 at 4-5)

4. Commission Conclusion

The AG objects to IAWC's proposal to include $212,600 in its revenue requirement for a "Retrospective Adjustment" or "Retrospective Accrual." The AG claims the proposal was not part of IAWC's original filing, that IAWC has consistently over-budgeted its insurance expense, and that IAWC and its affiliates have received "sizable refunds" relating to insurance over the past few years. Staff originally objected to recovery of the Retrospective Accrual; however, based upon IAWC's rebuttal testimony, Staff withdrew its request.

IAWC argues that the AG does not understand the nature of the Retrospective Accrual and that it was included in IAWC's original filing but was not broken out. IAWC contends that the Retroactive Accrual represents additional expense above projected IOTG premiums.

The Commission understands the AG's concern and confusion regarding the Retroactive Accrual related to IOTG. It appears to the Commission, however, that IAWC has explained the nature of the Retroactive Accrual, and most of the concerns raised by the AG are not directly related to the Retroactive Accrual. The Retroactive Accrual is an expense above projected IOTG premiums, and there is no evidence indicating that the Retroactive Accrual is improper or unreasonable. The Commission concludes that the AG's proposed adjustment should not be adopted.

E. Non-Labor Inflation Adjustment

1. The AG's Position

The AG argues that “the deflation for 2009 requires that the Company’s non-labor inflation adjustment be removed.” (AG Initial Brief at 29-30) According to the AG, the Company has increased its non-labor Operations and Maintenance expenses by an inflation rate of 2.5%, which the Commission should remove, given the recent deflation reported by the United States Bureau of Labor Statistics. AG Cross Exhibit 16, an excerpt from the Bureau of Labor Statistics dated November 18, 2009, shows that inflation for the 12 months ended October 2009 was a negative 0.2%. This is consistent with the Livingston Survey, submitted as IAWC Exhibit 6.02 R2, showing the 2008 to 2009 estimates of both the Consumer Price Index ("CPI") and the Producer Price Index ("PPI") are both negative, showing deflation.

As Mr. Smith pointed out, to the extent that IAWC relied upon any positive estimate of generalized inflation from 2008 to 2009 in developing its 2009 expenses, to which IAWC seeks to apply an additional inflation factor for 2010, these prior assumptions of 2009 inflation were wrong. (AG/JM Ex. 5.0 at 31-32) Mr. Smith removed $244,000 to reverse IAWC’s non-labor inflation adjustment. (AG/JM Ex. 5.1, Sch. C-2)

In Surrebuttal, IAWC witness Kerckhove suggested that the Livingston Survey should be disregarded because it is based on a “forecasted inflation rate.” (AG Initial Brief at 30, citing IAWC Ex. 6.00 SR at 26) Although he suggested that the CPI reported by the Bureau of Labor Statistics for the 10 months ended October 31, 2009 was 2.3%, in fact, AG Cross Exhibit 16 shows that the Bureau of Labor Statistics reported that unadjusted inflation for the 12 months ended October 2009 for “all items” was negative 0.2. In the AG’s view, Mr. Kerckhove’s suggestion that the Livingston estimate of deflation is irrelevant in light of actual inflation (or deflation) reports mistakenly finds inflation where deflation was reported.

Mr. Smith did not recommend that IAWC’s non-labor expenses be reduced to reflect deflation. However, he did point out that it is inappropriate and unfair to ratepayers to inflate non-labor expenses when there is effectively no inflation in the economy. The AG’s position is that the Commission should remove the inflation factor from IAWC’s expenses. (AG Initial Brief at 30)

2. IAWC's Position

IAWC takes issue with the AG’s position. (IAWC Initial Brief at 33-35; IAWC Reply Brief at 18) The AG argues that IAWC’s use of a 2.5% non-labor inflation rate should be rejected. IAWC says the AG’s position overlooks the fact that, while the Company’s test year forecast was prepared using a 2.5% general inflation adjustment for certain non-labor O&M expenses in 2009 and 2010, on rebuttal, the Company proposed to apply to certain non-labor expenses a 1.7% general inflation adjustor to forecast the respective test-year expenses. (IAWC Exs. 6.00R2 at 11; 6.01R2) The AG's argument is that inflation was negative for the 12 months ended October 2009. (AG Initial Brief at 30)

In IAWC's view, the 1.7% inflation projection is reasonable, and is supported by the fact that actual inflation in year-to-date 2009 was positive and above 2%. According to the U.S. Government's Bureau of Labor Statistics, the CPI for the 10 months ended October 31, 2009, is 2.3%; according to the U.S. Government's Bureau of Labor Statistics, the PPI for the 10 months ended October 31, 2009, is 2.6%. (IAWC Ex. 6.00SR at 26) Thus, IAWC argues, its proposed 1.7% general inflation adjustment is supported by 2009 inflation data. (IAWC Reply Brief at 19)

3. Commission Conclusion

The Commission has reviewed the parties' arguments, as well as the information in the record regarding inflation. As noted above, the AG urges the Commission to eliminate, from test-year expenses, the non-labor inflation adjustment proposed by IAWC.

Page 1 of the Livingston Survey shows CPI inflation declining at an annual rate of 0.7 percent from 2008 to 2009 but increasing at annual rate of 1.7 percent from 2009 to 2010. The text of the Livingston Survey does not discuss the forecasts of inflation from 2008 to 2009, which is not surprising given that actual data is available. The Commission believes that the Livingston Survey supports IAWC's inflation estimate rather than the AG's.

Turning to AG Cross Ex. 16, the AG is correct that the percentage change in CPI, for all items, for the 12 months ended October 2009 is negative 0.2 percent. Page 3 of that same Exhibit, however, shows that the change in CPI for all items less food and energy for the 12 months ended October 2009 is positive 1.7 percent. Additionally, the change in CPI for commodities less food and energy commodities for the 12 months ended October 2009 is positive 2.3 percent.

IAWC witness Mr. Kerckhove testified that according to the U. S. Government's Bureau of Labor Statistics, the CPI for the 10 months ended October 31, 2009, is 2.3%. He also testified that according to the U. S. Government's Bureau of Labor Statistics, the PPI for the 10 months ended October 31, 2009, is 2.6%. (IAWC Ex. 6.00SR at 26-27)

The Commission understands the AG's concern; however, the record, when viewed in its entirety, supports IAWC's proposed inflation adjustment of 1.7%. The Commission concludes that the AG's proposal to remove the adjustment is not supported by the record and it is not adopted.

F. The Gross Revenue Conversion Factor

1. The AG's Position

AG/JM witness Ralph Smith calculated the Gross Revenue Conversion Factor that used the specific uncollectible factor for each of IAWC's service districts. This is appropriate, the AG argues, because IAWC creates a different revenue requirement for each district, and a direct measurement of this expense results in a more accurate assignment of costs. (AG Initial Brief at 46-47) The gross revenue conversion factor for each district is found at AG/JM Ex. 5.1, Sch. A-1, page 2, and should be used in calculating IAWC's revenue requirement.

IAWC objected to this per-district calculation and asserted that the Company uses a statewide average for uncollectibles. However, the AG asserts, where there is district-specific information available, the use of statewide cost (or uncollectible) information is unnecessary and may distort the appropriate assignment of costs to the districts. Arguments about whether uncollectibles should be allocated by customer count, volume, revenues, or other variables are avoided when the uncollectible expense is determined for each district. In the AG's view, the Commission should use the district-specific uncollectible information available in this docket in preference to statewide information which must then be allocated among the Districts.

In addition to being more accurate for each district, the AG argues, Mr. Smith's uncollectible expense resulted in a lower overall uncollectible factor for purposes of the gross revenue conversion factor. Although the Company used a statewide, 1.2% uncollectible factor, Mr. Smith demonstrated that a more accurate statewide uncollectible factor, based on a district-up analysis, was 1.17%. (AG Initial Brief at 47) Accordingly, the Commission should apply the gross revenue conversion factor recommended by AG/JM witness Smith.

2. IAWC's Position

IAWC disagrees with the AG's recommendation. (IAWC Initial Brief at 71; IAWC Reply Brief at 58-59) The Company maintains uncollectibles on its books at the state corporate level. The Company calculated a Company-wide uncollectible factor of 1.2% of revenues, based upon the Company's actual uncollectible experience for the 12-month period ended May 2009. For the current year (2009) and the test year, the Company revised its allocation method to allocate uncollectibles to each rate area based upon each rate area's relative portion of water and wastewater revenues, exclusive of miscellaneous revenues.

AG/JM witness Mr. Smith developed his proposed Rate Area-specific factors by dividing uncollectible expense amounts, allocated using the customer count by Rate Area for 2007 and 2008, by the respective rate area historic revenues. According to IAWC, because the Company projects test year uncollectible expense as a percentage of revenue, Mr. Smith's calculation distorts the uncollectibles rate for individual districts by allocating the uncollectibles expense based on customer counts in 2007 and 2008, rather than based on revenue. (IAWC Reply Brief at 59; IAWC Ex. 6.00SR at 24-25) Moreover, Mr. Grubb testified that the distribution of customers in the Company's Rate Areas has changed recently (due to the elimination of double counted residential customers) (IAWC Ex. 5.00SR at 4), thereby rendering Mr. Smith's 2007 and 2008 customer count allocations outdated. In addition, use of a uniform uncollectible rate for all rate areas is consistent with the practice approved in the Company's last three rate cases. (IAWC Reply Brief at 59) Therefore, IAWC argues, the AG's recommendation should be rejected.

3. Commission Conclusion

AG/JM witness Mr. Smith calculated the Gross Revenue Conversion Factor that used the specific uncollectible factor for each of IAWC's service districts. The AG/JM argues that because IAWC creates a different revenue requirement for each district and a direct measurement of this expense, its proposal results in a more accurate assignment of costs. IAWC objects to AG/JM's proposal, claiming it is inconsistent with past practice and is based upon outdated information.

The Commission has reviewed the evidence and the parties' positions. The Commission does not find IAWC's argument that its proposal is consistent with past practice to be compelling given that in this proceeding, the AG/JM have provided alternative calculations of the uncollectible factors for each rate district, which were absent from previous IAWC rate cases. (AG/JM Ex. 5.1, Schedule A-1) The Commission also finds convincing AG/JM's assertion that its proposal to calculate a district-specific uncollectibles factor produces a more accurate estimate of the district specific revenue requirement. While IAWC contends that AG/JM's calculations rely on outdated information, it did not provide corrected calculations, maintaining that a statewide calculation is sufficient. Of the two proposals in the record, the Commission finds that AG/JM's is superior to IAWC's and should be adopted for purposes of this proceeding.

G. Increase in Balance of Unrecovered Rate Case Expense from Prior Docket

1. Staff's Position

A portion of the rate case expense authorized in Docket No. 07-0507, which was subject to a three-year recovery period, has not yet been recovered. Staff and the AG take issue with what they view as an increase in the amount authorized in Docket No. 07-0507. The AG also takes issue with IAWC's request to recover the unamortized balance at all, which is the subject of the following subsection, "Recovery of Unamortized Balance of Prior Rate Case Expense."

Staff witness Wilcox proposed an adjustment to reduce the amount of prior rate case expense to be amortized in the test year. (Staff Initial Brief at 13-14) This adjustment was necessary in Staff's judgment because the Company included, in the unamortized balance of rate case expense from its last rate case (Docket No. 07-0507), more rate case expense than the Commission authorized in that rate case. While the Company is entitled to include in the current rate case the unamortized rate case expense from its prior rate case, the Company should not include more than the Commission approved in Docket No. 07-0507, in Staff's view. (Staff Exhibit 2.0 at 3)

Company witness Bernsen disagreed. He testified that IAWC was ordered by the Commission in Docket No. 05-0681 to conduct a Municipal Rate Study, which the Company did in conjunction with its next rate case (Docket No. 07-0507). Mr. Bernsen argued that because the Municipal Rate Study was of a "unique nature," the Company should be allowed to recover all of the costs associated with the study including those in excess of the amount approved by the Commission. (IAWC Ex. 7.00R1 Rev. at 1-2)

Staff believes there is no merit to the Company's argument. The Company should not be allowed to amortize any component of rate case expense in excess of that approved by the Commission. Mr. Bernsen acknowledged in his response to Staff Data Request LHW 11.01, "The Docket 05-0681 Order did not state or imply a determination as to whether the Company would be permitted to recover as Rate Case Expense costs related to preparation of evidence on municipal rate comparisons that were greater than those ultimately approved by the Commission." (Staff Ex. 9.0 at 2)

Staff Data Request LHW 11.02 invited Mr. Bernsen to "cite precedent from any Commission rate proceeding wherein a utility was permitted to recover as a Rate Case Expense costs greater than those approved by the Commission." He responded (in part) as follows:

> In Docket No. 95-0076, the Commission approved recovery of the unamortized balance of the (higher than approved) actual cost of a depreciation study prepared for the prior rate case (Docket No. 92-0116). In Docket No. 92-0116, the Commission approved recovery of the amount of unamortized prior rate case expense incurred in Docket No. 90-0100. In Docket No. 02-0690, the Commission approved recovery of the unamortized balance of (lower than approved) actual prior rate case expense from Docket No. 00-0340.

To Staff, the circumstances of Docket Nos. 92-0116 and 02-0690 do not appear to be relevant. In the former, the Commission purportedly approved unamortized prior rate case expense; that is not the point of contention. In the latter, the Commission approved recovery of the unamortized balance of (lower than approved) actual prior rate case expense; Staff's position is that IAWC may not amortize expenses higher than those approved by the Commission. The circumstances of Docket No. 95-0076 would appear to be relevant; however, there is no reference to a depreciation study contained in the Commission's Final Order. (Id.)

In summary, in Docket No. 07-0507, the Commission approved IAWC's recovery of $1,482,020 for rate case expense for that case. Included in this $1,482,020 total was $37,000 for a municipal rate study. The Company now proposes to retroactively adjust the amount the Commission approved for the municipal rate study and increase it to $224,047. Staff's adjustment limits the recovery of the unamortized rate case expense from Docket No. 07-0507 to the amount the Commission approved in that case. (Staff Initial Brief at 14-15)

2. The AG's Position

In Section III.D.1 of the AG's Initial Brief, the AG argues, "IAWC's Request to Increase the Prior Rate Case Expense Is Unjust and Unreasonable and Violates the Rule Against Retroactive Ratemaking." (AG Initial Brief at 32-34) In its last rate case, IAWC was allowed to recover $1,482,020 as a rate case expense, which was the full amount it requested and 2.2 times higher than the rate case expense in IAWC's prior rate case (Docket No. 02-0690). The 2007 rate case expense included a municipal rate study. IAWC now asks the Commission to increase its 2007 rate case expense by $187,047 for the Municipal Rate Study – an amount that dwarfs the $37,000 original cost requested in 2007.

According to the AG, "In addition to being an outrageous increase over the allowed cost, IAWC's attempt to increase recovery for its 2007 rate case expense violates the rule against retroactive ratemaking." (AG Initial Brief at 33) The Supreme Court explained retroactive ratemaking as follows:

> Once the Commission establishes rates, the Act does not permit refunds if the established rates are too high, or surcharges if the rates are too low. (Business and Professional People I, 136 Ill.2d [192] at 209 (1989)) This rule is consistent with the prospective nature of the Commission's legislative function in ratemaking. In addition, this rule promotes stability in the ratemaking process. Citizens Utilities Co. v. Illinois Commerce Commission (1988), 124 Ill.2d 195, 207. (BPI II, 146 Ill.2d at 243)

In BPI I, the AG asserts, the Court held that the rule against retroactive ratemaking prohibited the Commission from adopting an order that included "retroactive rate refunds" to Commonwealth Edison customers. (136 Ill.2d at 213; see also Id. at 205-206, 209) In Citizens Utilities Co. the Court held that the Commission unlawfully reduced the utility's rate base to account for tax benefits the Company had obtained years earlier. (124 Ill.2d at 206) In Citizens the Court emphasized that utilities are only authorized to charge the rates approved by the Commission, and that both surcharges and refunds were prohibited to either increase rates or return funds when expenses were found to be different from what the Commission approved. (124 Ill.2d at 207)

IAWC is asking the Commission to effectively add a surcharge to rates to compensate the Company for the difference between the rate case expense level included in current rates (based on the expenses included in the test year that ended June 30, 2009), and the actual expense incurred by the Company in 2009. In the AG's view, this adjustment effectively charges ratepayers for an expense that exceeded the amount allowed by the Commission in IAWC's last rate case, while shielding shareholders from the consequence of IAWC's inaccurate projection of that cost. This kind of "retroactive adjustment," the AG argues, violates the rule against retroactive ratemaking and undermines rate stability and should be denied. (AG Initial Brief at 33-34)

3. IAWC's Position

IAWC disagrees with the recommendations of Staff and the AG. (IAWC Initial Brief at 35-36; IAWC Reply Brief at 19-21) The Company initially projected a cost for the Municipal Rate Study of $37,000, which was the cost level allowed by the Commission in Docket No. 07-0507. The Commission also determined in Docket No. 07-0507 that the cost of the Municipal Rate Study should be amortized over five years. The actual cost of the Municipal Rate Study was $224,047, which exceeded the amount projected. In this proceeding, IAWC proposes to recover the unamortized balance of the actual cost, $187,047, amortized over the three-year period remaining of the original five-year amortization approved in Docket No. 07-0507 (resulting in a test year amount of $62,349). (Staff Ex. 2.0, Schedule 2.1; Schedule C-10)

In accordance with the Commission's Order in Docket No. 07-0507, IAWC will recover the cost of the Municipal Rate Study through the time of the Order in this proceeding based on the initial cost estimate. IAWC believes, however, with respect to the Municipal Rate Study, the proposal to recover cost going forward (under the rates approved in Docket No. 09-0319) for the remainder of the amortization period based on the actual cost incurred is reasonable. (IAWC Ex. 7.00R2 Rev. at 2-3) Due to the unique nature of the Municipal Rate Study, its cost was difficult to predict at the time the Company filed Docket No. 07-0507. Moreover, the issue of municipal rate comparisons, previously addressed by the Municipal Rate Study, has again been raised by certain parties in this proceeding. For that reason the Municipal Rate Study, prepared initially for Docket No. 07-0507, was used by Mr. Uffelman as a basis for the updated analysis of rate comparisons presented by IAWC in this proceeding. (IAWC Exs. 10.00R; 10.00SR)

The AG asserts that IAWC's request to include the amortization amount of $62,349 in its present level of test year rate case expense is improper retroactive ratemaking, because, "IAWC is proposing that the Commission effectively add a surcharge to rates to compensate the Company for the difference between the rate case expense level included in current rates (based on expenses included in the test year that ended June 30, 2009), and the actual expense incurred by the Company in 2009." (AG Initial Brief at 33) IAWC contends, however, that it is not proposing to establish a surcharge. Instead, IAWC is seeking to include in its test year level of amortized rate case expense, for this proceeding, a cost not previously recovered for a study utilized by IAWC in both this and the prior rate proceeding. (IAWC Reply Brief at 19-20)

Staff argues that "[t]he Company should not be allowed to amortize any component of rate case expense in excess of that approved by the Commission." In response, IAWC considers recovery of the $62,349 amortization amount related to the actual cost incurred for the Municipal Rate Study appropriate under the circumstances. Moreover, IAWC has identified a case where the Commission approved recovery of the unamortized balance of the (higher than approved) actual cost of a depreciation study prepared for the prior rate case. (See Illinois-American Water Co., Docket No. 95-0076) Likewise, Staff points to a case (IAWC's 2002 rate case, Docket No. 02-0690), where, "the Commission approved recovery of the unamortized balance of (lower than approved) actual prior rate case expense." (Staff Initial Brief at 14) The Commission has, therefore, approved recovery of the unamortized balance of the actual cost of a prior rate case expense where it was less than the forecasted (and approved) level of cost. IAWC submits that, where circumstances have produced an amount of rate case expense for a particular item that is above what was initially forecasted (and allowed), recovery of the actual cost over an amortization period may and, under the circumstances in this proceeding should, also be permitted. (IAWC Reply Brief at 21)

4. Commission Conclusion

Most rate case expense authorized in Docket No. 07-0507 was subject to a three-year recovery period and for that reason has not yet been fully recovered. Staff and the AG take issue with IAWC's request to increase the unamortized balance of rate case expense from that docket to reflect the actual cost of a municipal rate study. They view the Company's request as an inappropriate increase in the amount authorized in Docket No. 07-0507. It is noted that the AG also takes issue with IAWC's request to recover any portion of the unamortized balance; that issue is the subject of the following subsection, "Recovery of Unamortized Balance of Prior Rate Case Expense."

As noted, the item at issue is the cost of a municipal rate study. The Company initially projected a cost for the Municipal Rate Study of $37,000, which was the cost level allowed by the Commission in Docket No. 07-0507 as part of approved rate case expense. Ultimately, the actual cost of the study was $224,047.

Having reviewed the record, the Commission agrees with Staff and the AG that IAWC should not be permitted to increase the unamortized balance of rate case expense approved in Docket No. 07-0507 by substituting the actual cost of the municipal rate study for the amount that was authorized in Docket No. 07-0507. The rates in that docket were set based on the expenses authorized at that time, including the municipal rate study item as part of rate case expense. That case is over. To now allow IAWC to use the instant proceeding as a means of revisiting or reopening Docket No. 07-0507, and increase the amount of the unamortized balance at this time, would essentially impose a surcharge on ratepayers by giving retroactive effect to the increase in the previously approved cost of the study. That is, the revenue requirement approved in that docket would in effect be retroactively increased. The fact that the study was allegedly "unique" and its cost was difficult to predict does not provide justification for such action.

H. Recovery of Unamortized Balance of Prior Rate Case Expense

1. The AG's Position

In Section III.D.2.a of its Initial Brief, the AG argues, "Rolling the 2007 Rate Case Expense into the 2010 Test Year Is Prohibited Single Issue Ratemaking." (AG Initial Brief at 34-36) In IAWC's last rate case, it was allowed to recover its full rate case expense, with the cost of the depreciation and the municipal rate studies (equaling $171,520) amortized over five years and the remainder of the expense amortized over three years. (AG/JM Ex. 1.0 at 34) The Commission did not, the AG argues, authorize IAWC to defer the unamortized portion of the rate case expense for future recovery if it filed a rate case before the end of the amortization period.

Notwithstanding the lack of specific authorization to defer and amortize the rate case expense, IAWC has assumed in its filing that it is entitled to add the unrecovered balance of the 2007 rate case expense to this year's rate case expense. Adding the 2007 expense to the 2010 test year expenses, however, violates the rule against single-issue ratemaking in AG's view because it adds costs outside the test year from one category of expense to the 2010 test year used to set future rates. In the AG's view, this distorts the ratemaking formula that aggregates all of the utility's costs and revenues for a test year to determine a revenue requirement, violates Illinois law, and should be rejected.

It is well established that utility rates are established on the basis of a test year. In Part 285 of the Commission's rules, a utility seeking to increase rates must present extensive data showing its costs for a 12-month period. (83 Ill. Adm. Code 285) The utility has the option of choosing a future or a historical test year. (83 Ill. Adm. Code 287.20) The test year is used to accurately determine the utility's revenue requirement and to prevent a utility from overstating its revenue requirement by mismatching low revenue data from one year with high expense data from a different year. (Business and Professional People in the Public Interest v. Illinois Commerce Commission, 136 Ill.2d 192, 219 (1989) ("BPI I"); Business and Professional People in the Public Interest v. Illinois Commerce Commission, 146 Ill.2d 175, 238 (1991) ("BPI II"))

The prohibition against single-issue ratemaking is related to the test year rule. As the Supreme Court explained in BPI II:

> The rule against single-issue ratemaking recognizes that the revenue formula is designed to determine the revenue requirement based on the aggregate costs and demand of the utility. Therefore, it would be improper to consider changes to components of the revenue requirement in isolation. Often times a change in one item of the revenue formula is offset

> by a corresponding change in another component of the formula. For example, an increase in depreciation expense attributable to a new plant may be offset by a decrease in the cost of labor due to increased productivity, or by increased demand for electricity . . . . In such a case, the revenue requirement would be overstated if rates were increased based solely on the higher depreciation expense without first considering changes to other elements of the revenue formula. Conversely the revenue requirement would be understated if rates were reduced based on the higher demand data without considering the effects of higher expenses. (Id. at 244-245)

IAWC has asked the Commission to add 2007 rate case expenses to the 2010 test year, effectively and improperly overstating the revenue requirement by importing expenses from outside the test year in the AG's view. Savings or changes in other aspects of IAWC's operations during the test year or in past years could affect the overall profitability of the enterprise. Yet, the deferral and amortization that IAWC requests would isolate rate case costs so that they are recovered from future ratepayers irrespective of whether the Company's revenues in the prior years were, in the aggregate, sufficient.

In BPI II the Court held that the Commission could not include deferred depreciation costs in rates without violating the test year rule and prohibition against single-issue ratemaking. The Court pointed out that depreciation was an operating expense, and said: "the critical inquiry is not how much cash was paid in a given period, but rather how much did the value of the underlying asset decline during that period." (146 Ill.2d at 239) The test year matches operating expenses with the period of time that the expenses produce value to the consumer. As the BPI II Court stated, "Depreciation recognizes the cost of that portion of the asset which is expended in a given year, regardless of the time period in which the construction costs were actually paid." (Id.) The purpose of the test year is to match the utility's costs with the benefits produced by those costs.

According to the AG, Illinois law and ratemaking do not authorize a utility or the Commission to roll one expense, in this case the rate case expense, into future test years because this mismatches costs and revenues, as well as costs and the benefit produced by that cost. The AG believes the Commission should reject IAWC's attempt to recover past rate case expenses in future rates as impermissible single-issue ratemaking. (AG Initial Brief at 36)

In Section III.D.2.b of the AG's Initial Brief, the AG argues, "Rolling the 2007 Rate Case Expense into the 2010 Test Year Is Prohibited Retroactive Ratemaking." (AG Initial Brief at 36-37) In the AG's view, the prohibition against retroactive ratemaking, discussed above, also prohibits the Commission from adding uncollected 2007 expenses to the 2010 test year. Once a revenue requirement and rates are set, the utility is given the opportunity to manage its operations within the rates set by the Commission. A utility might successfully manage its operations so that it does not need to seek additional revenue for several years while earning a reasonable return for its shareholders. On the other hand, it may be unable to manage its operations to earn a reasonable return and seek additional revenues from the public.

Irrespective of how the utility fared in the prior years, when it resets its rates, the Commission only considers costs for the test year. The Commission may not reduce rates to reflect higher than authorized returns in prior years and it may not increase rates to reflect poorer performance in prior years. (See Citizens Utilities Co. v. Illinois Commerce Commission 124 Ill.2d 195, 207 (1988) (Commission erred by reducing utility's rates to account for prior cost reductions); BPI II, 146 Ill.2d at 243 (Commission may not add costs from prior years even though those costs were never included in rates))

Despite the fact that the Commission did not specifically address IAWC's rate case expense in Docket No. 07-0507 (other than to include it in the schedules), IAWC is treating its 2007 rate case expense as if the Commission allowed it to defer and amortize that cost. In the absence of such authorization, it is a violation of the rule against retroactive ratemaking to add costs from 2007 to 2010 expenses for purposes of setting rates, in the AG's view. (AG Initial Brief at 37) By unilaterally including unamortized 2007 rate case expenses in the 2010 test year, the Company is effectively pancaking rate case expenses, where costs from years past accumulate year by year so that ratepayers become responsible for historical as well as current costs. The General Assembly's directive to the Commission to "specifically assess the justness and reasonableness of any amount expended by a public utility to . . . litigate a general rate case filing" mandates that unauthorized deferral of this cost be denied. (AG Initial Brief at 37)

In Section III.D.2.b of the AG's Initial Brief, the AG argues, "The 'Normalization' Approach Discussed By AG/JM Witness Smith Is Consistent With Illinois Law And Illinois Ratemaking Rules." (AG Initial Brief at 37-39) Commenting on the Commission's statement in an Ameren rate order allowing Ameren to recover the unamortized balance of rate case expense, AG/JM witness Ralph Smith discusses the accounting policies and reasons for rejecting the deferral and amortization approach proposed by IAWC and using a normalization approach that establishes a "representative and normal annual level of reasonably and prudently incurred regulatory expense." (AG/JM Ex. 1.0 at 42) Mr. Smith testified:

> Although the amortization treatment afforded rate case expense previously effectively treats the rate case expense as an asset, rate case costs do not meet the criteria for a regulatory asset of volatility and materiality and should not be afforded regulatory asset treatment. The ratemaking treatment of such costs should therefore provide for a normalized expense allowance (similar to other O&M expenses), rather than the establishment of a regulatory asset that is amortized prospectively. The purpose of the rate case allowance should be to include in rates a representative and normal annual level of reasonably

> and prudently incurred regulatory expense, rather than to provide the utility with guaranteed dollar-for-dollar cost recovery. Consistent with such normalization treatment of this expense, IAWC should not establish an asset for deferral of the current rate case cost and should not record amortization. Once a normalization approach is adopted, any remaining amortization of prior case balances would be replaced by a new representative, normalized rate case expense in IAWC's next rate case.

Mr. Smith further testified that a normalization approach, which is ordinarily used for operations and maintenance expenses, does not deny the utility the opportunity to recover its reasonably and prudently incurred costs. He stated on page 43:

> Normalization treatment provides the utility an opportunity to recover a normalized level of reasonable and prudently incurred cost, but does not single out one item of O&M cost – rate case expense – for a special guaranteed recovery (and potential for over-recovery) that is different from other O&M expenses. Normalization treatment merely treats rate case cost similarly to other test year O&M costs which are reflected in rates based on "normal" levels found to be reasonable in a test year. O&M expenses are not normally singled out for specific deferral and recovery, and normalization treatment is deemed reasonable for ratemaking purposes. Exact dollar-for-dollar recovery of other O&M expenses that are found to be reasonable and prudently incurred in a test year is not guaranteed; however, it is generally considered that a utility, if managed prudently, has been provided with an opportunity to recover such reasonable and prudently incurred expenses. A utility's rate case cost should be no different. As explained above, rate case cost can, and I recommend should, be treated on a normalized basis, similar to other O&M expenses that are reasonable and prudently incurred in a test year and are not singled-out for guaranteed recovery.

Consistent with normalization of the rate case expense, the AG argues, the rate case expense determined to be reasonable and prudent for the 2010 test year should be the only regulatory or rate case expense included in rates in this docket; no recovery for unamortized 2007 rate case expenses should be allowed. (AG Initial Brief at 39)

The AG next argues, "Without Waiving the Above Arguments, If the Commission Allows Recovery Of The Unamortized 2007 Rate Case Expense, IAWC Should Not Be Allowed To Increase Costs To Consumers By Changing the Amortization Period Allowed In Docket 07-0507." (AG Initial Brief at 39)

AG/JM witness Smith presented an amortization period that is fairer to consumers than the period proposed by IAWC, in the AG's view. As AG/JM witness Mr. Smith demonstrated on AG/JM Exhibit 5.1, Schedule C-3, page 2, IAWC's proposal to shorten the amortization period for some expenses while extending it for others will cost ratepayers an extra $156,215 compared to Mr. Smith's proposal to synchronize the previously approved three-year amortization period with the current rate case expense, and keep the remainder of the five-year amortization period for the expenses currently subject to the five-year amortization.

2. IAWC's Position

With respect to allowed prior rate case expense, IAWC argues, recovery of unamortized balances is routinely permitted under longstanding Commission practice, and the AG's recommendations should be rejected. (IAWC Reply Brief at 21-22)

As explained in IAWC's Initial Brief, pages 44-45, because rate case expenses do not routinely occur every year, such expenses are routinely amortized over an appropriate period of time and the Commission has routinely, and for many years, approved the deferral and amortization of rate case expense. (Central Illinois Public Service Co. v. Illinois Commerce Comm'n, 243 Ill. App. 3d 421, 432 (4th Dist. 1993); see, e.g. Docket Nos. 92-0116, 95-0076, 02-0690, 06-0070 (Cons), 07-0507, 07-0585 (Cons)) Deferral and amortization of rate case expense results in a normalized test year level of rate case expense. (IAWC Ex. 7.00SR at 6) The Commission has explained that, where there are wide annual fluctuations in an expense, "the amount projected to be expended in any given test year may not be representative of a normal year. Therefore, deferred amounts may be used to help arrive at a more normal or representative test year allowance as an alternative to unrepresentative test year projections . . . ." (IAWC Reply Brief at 22, citing Illinois-American Water Co., Docket No. 02-0690, Final Order at 16-17)

Some portion, but not all, of rate case expense may be incurred in the test year (for example, in Docket No. 09-0319, a small portion of rate case expense will be incurred in the 2010 test year). Amortization of the total projected level of rate case expense over the expected life of the rates results in a normalized test year level of rate case expense. (IAWC Ex. 7.00SR at 6) Depending on the timing of the next rate case, some amounts may still be in the process of amortization, and as such would be included in the normalized level of test year rate case for the next rate case, consistent with test year rules.

Following BPI II, the Commission has made clear that there are certain types of expenses for which amortization and deferral are consistent with test year rules and can be allowed. (IAWC Initial Brief at 47-48; Reply Brief at 23) This is confirmed by the fact that the Commission has routinely approved amortization as a proper way to "normalize" costs which would otherwise fluctuate greatly, including rate case expense. See Illinois-American Water Co., Docket No. 07-0507 (tank painting, rate case expense); Docket No. 02-0690 (tank painting, rate case expense); Docket No. 95-0076 (well and pump maintenance); Docket No. 92-0116 (current and prior rate case expense). As Staff points out in its Initial Brief, the Company is entitled to recover in the current rate case the unamortized rate case expense from its prior rate case. And, IAWC asserts, the Commission has routinely approved the recovery of unamortized balance of prior rate case expense in a subsequent case. See Illinois-American Water

Co., Docket No. 92-0116, 1993 Ill. PUC Lexis 46, 29-36 (Feb. 9, 1993); Illinois-American Water Co., Docket No. 02-0690; Commonwealth Edison, Docket No. 07-0566; Central Illinois Light Co., et al., Docket Nos. 07-0585 through 07-0590 (Cons.). Although IAWC did not obtain express authorization for recovery of the unamortized balance of prior rate case expense, no such approval is required by any order or rule, and no approval has been required in numerous orders which have allowed recovery of prior case allowed expenses. (IAWC Reply Brief at 23)

No witness in this proceeding proposed that recovery of the unamortized balance of allowed prior rate case expense be denied. In fact, AG/JM witness Smith expressly addressed the amortization period for prior rate case expense (as discussed below) and made no recommendation to deny recovery of the unamortized balance of prior rate case expense. (AG/JM Ex. 1.0 at 34-35)

The AG's contention that recovery of the unamortized balance of prior rate case expense violates the rule against single-issue ratemaking should be rejected, in IAWC's view. (IAWC Reply Brief at 24) The rule against single-issue ratemaking requires that the Commission examine all elements of the revenue requirement formula to determine the interaction and overall impact any change will have on the utility's revenue requirement. (BPI II, 146 Ill. 2d at 244) All components of the revenue requirement, however, are under review in this rate case. As discussed above, such items as tank painting activity, rate case activity, well and pump maintenance or other items may be projected to be above or below "normal" levels. Where there are wide annual fluctuations in an expense, "the amount projected to be expended in any given test year may not be representative of a normal year" and other methods of calculating such expenses may be used. (Illinois-American Water Co., Docket No. 02-0690, Final Order, at 16) Where the fluctuation of a particular item is significant, a normalization rate-making approach is often deemed appropriate by the Commission. The normalized level of these expenses (including unamortized rate case expense from a prior case) are routinely considered and approved by the Commission, without a finding that they constitute single-issue ratemaking.

Likewise, IAWC argues, the AG's contention that recovery of an unamortized balance of prior rate case expense violates the rule against retroactive ratemaking should also be rejected. IAWC is not proposing refunds of rates approved in the past or any surcharge. As discussed above, the Commission has routinely approved the recovery of the unamortized rate case expense from a prior rate case, and approved such recovery without a finding that it is improper retroactive or single-issue ratemaking.

The AG also contends, with reference to AG/JM witness Smith's "normalization" approach, that "[c]onsistent with normalization of the rate case expense, the rate case expense determined to be reasonable and prudent for the 2010 test year should be the only regulatory or rate case expense included in rates in this docket. No recovery for unamortized 2007 rate case expenses should be allowed." (AG Initial Brief at 39) As IAWC discussed in its Initial Brief, pages 46-48, Mr. Smith did not explain how his "normalization" approach would work. (IAWC Reply Brief at 25) Mr. Smith also did not indicate that his “normalization” approach should apply to prior rate case expense; rather, his discussion was directed prospectively toward future rate cases. (AG/JM Ex. 1.0 at 42) The AG does not explain why the concept of normalization precludes recovery of prior rate case expense still in the process of amortization. Deferral and amortization of rate case expense, including prior rate case expense, however, is a form of normalization.

The AG suggests, as a fallback (AG Initial Brief at 39), a modification of the amortization period for the components of unrecovered prior rate case expense. AG/JM witness Mr. Smith (AG/JM Ex. 5.0 at 35) recommended that Commission-approved unamortized amounts from the prior case having a remaining amortization period of 15 months as of April 30, 2010 be amortized over the same amortization period that the Commission approves in this case. The Company agreed that this amount should receive the same amortization period that is applied to the expense for the current case (the Company is proposing a 2-year amortization period for current rate case expense). (IAWC Ex. 7.00SR at 3) Mr. Smith (AG/JM Ex. 5.0 at 35) also recommended that Commission-approved unamortized amounts from the prior case having a remaining amortization period of 39 months as of April 30, 2010 continue to be amortized using the 39-month amortization period as previously approved. As Mr. Bernsen explained, however, for the components of unamortized prior rate case expense having a remaining amortization of 39 months, IAWC is proposing a 36-month amortization period. This is not unreasonable given the small variation in months. The use of a 36-month amortization period would allow the amount to be amortized over exactly 3 years. (IAWC Ex. 7.00SR at 3)

3. Conclusion

As noted above, most rate case expense authorized in Docket No. 07-0507 was subject to a three-year amortization period and for that reason has not yet been fully recovered. The AG also takes issue with IAWC’s request to recover the unamortized balance from the previous case.

Having reviewed the arguments, the Commission finds that the AG’s proposal should not be adopted. Because rate cases do not occur every year, the Commission routinely orders that approved rate case expense be amortized over a multiple-year period; a ratable portion is included in test year expense, as it was in Docket No. 07 0507, and is recovered through rates. If the balance will not be fully amortized by the time new rates are approved in the next rate case, the Commission has allowed the unamortized amount to be recovered through rates approved in the new docket. Thus, IAWC’s proposal is in accord with prior Commission orders.

Further, although the AG has argued that allowing the recovery of the unamortized balance from Docket No. 07-0507 would be retroactive ratemaking, the opposite argument could just as easily be made. What the AG appears to proposing -- using the instant rate docket to decrease to zero the unamortized balance of rate case expense approved in the prior rate case -- is essentially the flipside of the IAWC adjustment rejected in the subsection of this Order immediately above; there IAWC was trying to use the instant case to change, i.e. increase, the amount of rate case expense approved in Docket No. 07-0507. Here, the apparent effect of the AG's proposal, by denying recovery of the remaining portion of the amount authorized in Docket No. 07 0507, would be to use the current docket to retroactively change, i.e. decrease, the revenue requirement approved in the prior docket.

The Commission also notes that the fact the unamortized balance of rate case expense is not included in rate base actually helps ratepayers, as no return on the balance is recovered from ratepayers.

Regarding the amortization period for the unamortized, i.e., unrecovered balance of rate case expense approved in Docket No. 07-0507, the Commission finds that this amount, on a going-forward basis, should be rolled into the same three-year amortization period as is approved below for most current rate case expenses.

I. Current Rate Case Expense

The Company is requesting a current rate case expense of $2,339,496. (IAWC Schedule C-10) IAWC proposes to recover the expense over a two-year amortization period.

1. The AG's Position

The Public Utilities Act requires the Commission to "specifically assess the justness and reasonableness of any amount expended by a public utility to compensate attorneys or technical experts to prepare and litigate a general rate case filing. The issue shall be expressly addressed in the Commission's final order." (220 ILCS 5/9-229 (effective July 1, 2009))

At the outset, the AG states that the $2.34 million rate case expense requested by IAWC is 58% higher than the $1.48 million 2007 rate case expense. (AG/JM Ex. 5.0 at 36; AG/JM Ex. 5.1, Sch. C-4, page 1) The AG argues, "Rate Case Expense IAWC Requests for This Case Is Unreasonable and Must Be Adjusted to a Reasonable Level." (AG Initial Brief at 40-46)

In Section III.E.1, the AG addresses legal fees and expenses. IAWC requested $930,000 in legal fees and expenses in this docket. This represents an increase of 43% over the 2007 legal fees and expenses requested and allowed in IAWC's last rate case, Docket No. 07-0507. According to the AG, IAWC has offered no reason for the difference between this case and its last case; rather, it simply asserts that its attorneys are experienced and highly qualified. (AG brief at 40; AG/JM Ex. 5.0 at 38)

Mr. Smith asserted that an increase of 43% in a single expense item is unreasonable, particularly in light of the poor economy, high unemployment, and the deflation of the past year. (AG/JM Ex. 1.0 at 39)

Mr. Smith recommended that legal fees and expenses increase by no more than 10% over the last rate case, which would cap the legal fees and expenses at $715,000. (AG/JM Ex. 5.0 at 44) However, the AG argues, the Commission can also determine that no increase from the $650,000 legal fees and expenses requested and allowed in the 2007 rate case is justified. The 2007 expense was more than 80% higher than the 2002 expense of $357,876 for essentially the same work: presenting a rate increase request. (AG Initial Brief at 41)

These are huge numbers, the AG argues, and the increases over prior allowed expenses should lead the Commission to find them unreasonable. In light of recent deflation, the economic pressure facing consumers and local governments, and the unexceptional nature of this rate case, the 43% increase in legal fees and expenses requested by the Company is simply unacceptable, in the AG's view. The Commission should limit the Company's legal fees and expenses to the amount allowed in 2007, or at the most, increase them by 10%, the AG contends. (AG Initial Brief at 41-42)

The AG next argues, in Section III.E.2 of its Initial Brief, that the service company study cost is "outrageous" and should be disallowed. (AG Initial Brief at 42-44) In IAWC's last rate case, the AG states, the Commission expressed concern over whether IAWC was "doing everything possible to ensure low costs for ratepayers," and it directed IAWC to compare the cost of Service Company services to the costs of such services had they been obtained through competitive bidding on the open market. (Docket No. 07-0507, Order at 30-31 (July 30, 2008)) In response, IAWC submitted the testimony of (1) Bernard L. Uffelman, IAWC Ex. 10.00, (2) Mark R. Young, IAWC Ex. 11.00, and (3) John S. Young, IAWC Ex. 12.00; as well as testimony by (4) IAWC President Karla Teasley, IAWC Ex. 1.00 at 15-26 and Ex. 1.04; Ex. 1.00 Supp; and testimony by (5) IAWC witness Edward J. Grubb, IAWC Ex. 5.00 at 2-12; Ex. 5.01-5.03, 5.03 Supp. A "Service Company Study" was prepared by Mr. Uffelman and Mr. Mark Young and submitted as IAWC Exhibit 11.01.

IAWC Exhibit 11.01 contains 22 pages of narrative, a 2-page Appendix with FERC Account Descriptions, and 8 schedules showing billing rates and hours worked for various service types.

IAWC President Karla Teasley presented a "Self Provision Study" which addressed corporate governance, customer service centers, and employee benefits, and those services were excluded from the study. (Tr. at 362)

Mr. Mark Young only prepared Direct Testimony. Mr. John Young prepared Direct Testimony about the Service Company and Surrebuttal Testimony on an unrelated issue that was later withdrawn. (Tr. at 430) Mr. Uffelman submitted direct, rebuttal and surrebuttal testimony, but his rebuttal and surrebuttal testimony addressed municipal witnesses unrelated to the Service Company Study. He appeared for cross-examination on the Service Company Study as well as municipal rates issues on one day.

Mr. Uffelman testified that he was retained to do the study in January, 2009, and he believed that five or six people prepared the Service Company Study. (Tr. at 363, 370) Although he did not know the number of hours it took to complete the study, he estimated it at 500 hours. (Tr. at 405) The AG says Mr. Uffelman did not exactly recall, but testified that he thought he received "125,000, 150,000 maybe" for the study, and would receive another 50,000, 60,000 something like that," for his testimony. (Tr. at 404-405) These amounts would equal $175,000 to $210,000 for the study and for his services. Yet, IAWC has asked for $422,900 for the 22-page, 8-schedule report.

In the prior rate case, Mr. Uffelman prepared a report entitled "Municipal Rate Study." (Docket No. 07-0507, Order at 31-44 (July 30, 2008)) IAWC requested $37,000 for that study on its Schedule C-10.1 in that case. (AG Cross Ex. 19) In this case, IAWC identified an additional $187,000 for that study. That cost is significantly less than the $422,900 IAWC is seeking for the Service Company Study. (AG Initial Brief at 42-43)

The cost for the Service Company Study can also be compared to the cost of service study and demand study submitted in this docket. IAWC is asking $249,540 for both the demand and the cost of service studies, which together produced hundreds of pages of cost information, analysis and proposed rates as well as testimony. J. Rowe McKinley submitted testimony and exhibits about the demand study. (IAWC Ex. 13.00, 13.00R1, 13.00 R2, 13.00 SR; a Report on Capacity Factors by Customer Class, IAWC Ex. 13.01 (April, 2009), a revised Report, IAWC Ex. 13.01 R1 (October 2009)) Testimony and exhibits sponsored by Paul Herbert address cost of service allocations as well as rate design for all customer classes. (See IAWC Ex. 9.00, 9.01 (cost of service studies) through 9.10)

According to the AG, It is hard to fathom how the Service Company Study, which basically multiplied the number of Service Company hours by hourly rates obtained from hourly rate surveys, could possibly justify more than $420,000 from ratepayers. IAWC has not met its burden of proof to justify recovery of this expense, the AG argues, and it should be disallowed. (See 220 ILCS 5/9- 201(c) ("the burden of proof to establish the justness and reasonableness of the proposed . . . charge . . . shall be upon the utility.")) The substance of the work product, the AG contends, simply does not justify the price tag. (AG Initial Brief at 44)

In Section III.E.3, the AG argues, "The Service Company Study Did Not Conform to the Commission Direction and Consumers Should Not Pay for It." (AG Initial Brief at 44-46) To some extent, this issue is also discussed in the section of the order addressing the reasonableness of management fees paid to the Service Company.

In its Order in Docket No. 07-0507, pages 30-31, the Commission stated:

> Because the Commission questions whether IAWC is doing everything possible to ensure low costs for ratepayers, the Commission directs IAWC

> to conduct a study comparing the cost of each service obtained from the Service Company to the costs of such services had they been obtained through competitive bidding on the open market. As part of the study, IAWC must also provide an analysis of the services provided by the Service Company to all of IAWC's affiliates. The analysis must provide details on the specific services provided to IAWC and how costs are allocated among affiliates of IAWC. IAWC shall include the study in its next rate filing.

In the AG's view, the Service Company Study submitted by IAWC is not based on competitive bids. (AG Initial Brief at 45-46) Further, the AG argues, the record shows that the study is not a proxy for competitive bidding because its structure removed key variables that non-affiliated vendors might modify to reduce their costs and their prices. The study did not consider the possibility that a non-affiliated provider could offer to provide the same services for fewer billed hours than the affiliated Service Company, at a lower or different hourly rate, at a different rate structure, with a different distribution of experience and hourly charges, at a fixed fee, or any other number of variables that competitors may devise to obtain business and achieve efficiencies.

The IAWC Service Company Study was not independent, and is of little if any help to the Commission, the AG contends. It does not assess whether IAWC could obtain the same services through competitive bidding at a lower cost, whether the Service Company uses a reasonable cost allocation methodology, whether IAWC is charged a reasonable amount, whether the services provided are necessary and prudent, and how the growth of Service Company charges could be staunched. (AG Initial Brief at 46)

2. Homer Glen, et al. (Municipalities) Position

Generally speaking, Homer Glen agrees with the arguments and recommendations made by the AG and the AG/JM's witness, Mr. Smith. (Homer Glen Initial Brief at 17-18) In Homer Glen's view, the Company has not justified why it should not be required to hold its recoverable rate case costs for such items as legal fees to the amount approved for recovery in its last rate case or why a utility affiliated with a large Service Company cannot make more extensive and economical use of service company support for its recurring rate cases, and thus economize on the cost of outside attorneys. (Homer Glen Initial Brief at 17, citing AG/JM Ex. 5.0 at 39)

Mr. Smith recommended that legal fees and expenses be limited to $715,000, which is a 10 percent increase over the $650,000 allowed by the Commission in Docket No. No. 07-0507. Mr. Smith noted that "during this period inflation was negative, and the recession has resulted in other businesses limiting expenses rather than increasing them by more than 10%." (AG/JM Ex. 5.0 at 43)

In addition to limiting legal fee recovery, the Commission should, in Homer Glen's view, disallow any recovery by IAWC for its Service Company Study since that study did not comply with the mandate by the Commission in Docket No. 07-0507. The design and execution of the study was imprudent, Homer Glen argues, and, as a result, all costs for it should be excluded from the revenue requirements in this case. (Homer Glen Initial Brief at 17-18)

As to the amounts that it does allow, the Commission should use a three-year amortization period to recover these costs rather than the two years requested by the Company.

3. Staff's Position

Staff witness Wilcox attached to his direct testimony the Company's responses to Staff Data Requests LHW 5.01 and LHW 7.01. The purpose was to provide a basis for the Commission to assess whether the Company's proposed expenditures to compensate attorneys or technical experts to prepare and litigate the instant proceeding were just and reasonable pursuant to Section 9-229 of the Act, 220 ILCS 5/9-229. Mr. Wilcox recommended that the Commission find that the proposed amounts to be expended by the Company for rate case expense in this proceeding, as adjusted by Staff, were just and reasonable. (Staff Initial Brief at 15, citing Staff Exhibit 2.0 at 2-4)

4. IAWC's Position

According to IAWC, AG and the Municipalities ignore the fact that IAWC's proposed test year level of rate case expense is less than the amounts actually incurred by IAWC for its prior case. Moreover, in suggesting that IAWC has not taken action to limit its expenses in the rate case, AG and the Municipalities ignore the extensive cost control measures related to rate case expense that have been implemented by IAWC. (IAWC Reply Brief at 26)

The Company's requested level of rate case expense for the current case is, IAWC asserts, a reasonable and accurate projection of necessary costs required to prosecute the current case, and should be recovered in rates. (IAWC Initial Brief at 36-43; Reply Brief at 26, citing Du Page Utility Co. v. Illinois Commerce Comm'n, 47 Ill.2d 550, 561 (1971) (costs incurred by a utility to prepare and present a rate case are properly recoverable as an ordinary and reasonable cost of doing business))

The Company is requesting a total rate case expense of $2,339,496. (IAWC Schedule C-10) The actual rate case expense of Docket No. 07-0507 was $2,347,164, which is $7,668 more than the projected cost of the current case. (IAWC Schedule C-10.1) The projected costs of Legal Fees and Expenses, Revenue Requirement and CPA Review are decreased from actual amounts in the prior case by 7%, 51% and 47%, respectively. (IAWC Schedule C-10.1) This projected level of rate case expense reflects careful analysis of prior case costs and incorporates cost-control measures implemented to minimize expenses. (IAWC Ex. 7.00R2 Rev.)

The Company sought to keep rate case expense as low as possible through implementation of various cost control measures. (IAWC Initial Brief at 36-40; Reply Brief at 27; IAWC Ex. 7.00R2 Rev. at 4) As IAWC witness Mr. Bernsen explained, these cost-control measures include the use of fixed fees for certain aspects of rate case expense, as well as contractual agreements for "not-to-exceed" amounts, or ceilings for certain expense categories, such as legal expense. (IAWC Ex. 7.00R2 Rev. at 4, 9) The Company has also utilized in-house legal counsel where appropriate. (IAWC Ex. 5.00SR at 12)

Recommendations to limit rate case expense to an amount at, or 10% above, the amount allowed in the last rate case are arbitrary, in IAWC's view. (IAWC Reply Brief at 27) Such recommendations ignore the Company's detailed projection of rate case expense for this case and do not allow the Company an opportunity to recover its prudent expenses. Neither the AG nor the Municipalities contest the need for legal services in this case, nor do they contend that the projected level of rate case legal expense is inaccurate. The Commission may not simply disregard the level of a utility operating expense as shown by evidence in a rate proceeding in favor of an arbitrary lower amount. (Peoples Gas Light & Coke Co. v. Slattery, 373 Ill. 31(1940))

Mr. Smith's 10% figure is based on data that does not reflect the actual amount spent by the Company in the previous rate case. (IAWC Ex. 7.00R2) The actual figure for rate case legal expense from the prior case is $997,904. Based on this number, the Company's projection actually reduces legal costs by 7% in the present rate case as compared to the actual costs required for the prior case.

Although IAWC is requesting a lower level of rate case legal expense in this proceeding than it incurred in the last, IAWC's current rate case expense projection includes the cost of a number of studies not performed in the prior case (such as the studies related to the Service Company's fees and the cost of service study). IAWC was also required in this case to perform a new demand study, based on a different (Commission-approved) methodology from the demand study in the prior case, and examine a variety of rate design issues. (IAWC Initial Brief at 37; Reply Brief at 29)

Contrary to the Municipalities' assertions, the Company does make economical use of in-house legal staff in Illinois rate cases; in-house legal staff are actively involved in rate cases in a variety of areas (for example, coordinating discovery and planning for and attending public hearings). (IAWC Ex. 5.00SR at 12) As explained by Mr. Grubb, however, the use of outside counsel is appropriate and allows the Company to save on the costs that would otherwise be incurred during the intervening periods between rate cases. (IAWC Initial Brief at 39-40; Reply Brief at 29)

IAWC also takes issue with the AG's and Municipalities' position that the cost of the Service Company Cost Study should be disallowed. (IAWC Initial Brief at 30-31)

The AG and the Municipalities assert that the cost of the Service Company Study be disallowed because the study did not comply with the Commission's requirements as set forth in Docket No. 07-0507. As discussed elsewhere in this Order, IAWC asserts that the Service Company Study, in conjunction with extensive accompanying evidence, fully complies with the Docket No. 07-0507 Order. No witness in this proceeding challenged the methodology or results of the Service Company Study, IAWC asserts, or recommended that the study's costs be entirely disallowed.

As discussed above, the AG also asserts that the cost of the Service Company Study is "outrageous" and should also be disallowed for that reason. (AG Initial Brief at 42) Of note, IAWC states, is that this position disregards the testimony of the AG's own witness, Mr. Smith, who recommends that recovery for the Service Company Study be limited to $366,000. (AG/JM Exs. 1.0 at 44-45; 5.0 at 43) In IAWC's view, the full cost of the Service Company Study is justified. (IAWC Initial Brief at 43-44; Reply Brief at 30-31) Not only was the Service Company Study consultant selected as a result of a competitive bidding process, the Service Company Study is subject to measured cost control efforts. (IAWC Ex. 7.00R2 at 6-7) At IAWC's request, the consultant agreed to a "not-to-exceed" amount for the production of the Service Company Study and related direct testimony, which was intended in part to ensure that the projection of the expense is reliable and that the amounts actually incurred for the Service Company Study are consistent with the projection.

Moreover, as of September 30, 2009, the Company had already incurred $357,371 for the Service Company Study. (IAWC Ex. 7.00R2 at 7)

AG also suggests that IAWC's $422,900 projected level of expense of the Service Company Study is too high, noting that Mr. Uffelman testified at hearing that, "[a]lthough he did not know the number of hours it took to complete the study, he estimated it at 500 hours," and he would receive "$175,000 to $210,000 for the Study and for his services." (AG Initial Brief at 43) These suggestions mischaracterize Mr. Uffelman's testimony, in IAWC's view. At the hearing, Mr. Uffelman was asked: "But can you give me an estimate of the number of hours you spent on the service company cost study?" (Tr. at 405) Mr. Uffelman responded that he had spent approximately 500 hours on the study. Likewise, the $175,000 to $210,000 was Mr. Uffelman's estimate of the fees paid him for the Service Company Study. (Tr. at 404-405) Furthermore, IAWC asserts, five or six people worked on the Service Company Study, including Mr. Mark Young. (Tr. at 370) Given that the referenced 500 hours and $175,000 to $210,000 in fees relate only to Mr. Uffelman's work on the study (and not that of other personnel involved), these references do not suggest that IAWC's projected cost of $422,900 for the entire Service Company Study is unreasonable, in IAWC's view. (IAWC Reply Brief at 31)

IAWC also argues that its proposed two-year amortization period for rate case expense is appropriate. (IAWC Initial Brief at 44-46; Reply Brief at 32)

In the Initial Briefs, IAWC states, the only opposition to IAWC's proposed amortization periods for current rate case expense (a five-year amortization for the cost of service study, demand study, and Service Company Study and a two-year amortization for all other components of current rate case expense) was from the Municipalities, who recommended a three-year amortization for amounts of rate case expense the Commission "does allow." (IAWC Reply Brief at 32) While IAWC would not object to amortization of the costs of the cost of service study, demand study, and Service Company Study over three, rather than five, years, IAWC continues to believe that a five year amortization of these components is reasonable.

With respect to other components of rate case expense, IAWC's proposed two-year amortization period is reasonable for the reasons given in IAWC's Initial Brief. (IAWC Initial Brief at 44-46; Reply Brief at 32) The proposed two-year amortization is appropriate, in IAWC's judgment, because the Company has projected a rate case cycle of two years given the need for capital investment in its facilities, and it is the Company's position that the amortization period should be set to match the period of time that rates will be in effect. (IAWC Initial Brief at 44; IAWC Ex. 7.00R2 at 8)

5. Commission Conclusion

The Company is requesting a total rate case expense of $2,339,496. The AG and Municipalities takes issue with IAWC's proposal. Staff, on the other hand, reviewed the Company's rate case expenditures, and found them to be reasonable.

Among other things, the AG complains, at the outset, that the $2.34 million rate case expense requested by IAWC is 58% higher than the $1.48 million 2007 rate case expense approved in Docket No. 07-0507, and that legal expenses are 43% higher.

IAWC responds that its actual rate case expense for Docket No. 07-0507 was $2,347,164, which is $7,668 more than the projected cost of the current case. (IAWC Schedule C-10.1) IAWC calculates the projected costs of legal fees and expenses, revenue requirement and CPA review to be lower than amounts actually incurred in the prior case by 7%, 51% and 47%, respectively.

The AG witness testified that legal expenses are excessive, and the amount allowed in this case should be no more than 10% higher than the amount approved in the last rate proceeding. IAWC contends that the legal services are necessary, and reflect cost-control measures utilized by IAWC.

The AG asserts that the cost of the service company study is "outrageous" and should be disallowed. On this issue, the Commission has found, elsewhere in this Order, that the service company cost studies performed by IAWC represent a reasonable effort to comply with the directive of the Commission in Docket No. 07-0507. This cost should not be eliminated from allowable rate case expense.

Regarding other rate case expense, including legal expenses, the Commission agrees with the conclusion of Staff, which entered into evidence numerous data request responses it reviewed in its assessment of fees to attorneys and technical experts, that the Company's rate case expenses are just and reasonable within the meaning of

Section 9-229 of the Act, 220 ILCS 5/9-229. The record shows that the services were reasonably necessary in the preparation and presentation of the case, and that the Company undertook reasonable measures to control the costs. Thus, while lowering rate case expense is a desirable goal, the record supports the inclusion, rather than disallowance, of the expense proposed by IAWC.

For future cases, the Commission directs IAWC to fully document its efforts to control rate case expense. Furthermore, in this order, in situations where future cost studies appear to offer potential benefits, the Commission is ordering IAWC to provide cost estimates for such studies so that the Commission will have the opportunity to determine if such studies are cost-effective before the costs are actually incurred and passed on to ratepayers.

With regard to the amortization period for rate case expense, the Commission finds that a five-year period should be used for the costs of the cost of service study, demand study, and SCCS. For other rate case expenses, IAWC's two-year proposal warrants consideration. However, upon consideration of the record, including intervals between prior rate cases, the Commission believes that a three-year period, proposed by the AG, should be used. As noted above, the Company will not earn a return, through rate base, on the unamortized balance, which is of benefit to ratepayers.

J. Approved Operating Income Statement

Upon reflecting on the effects of the determinations made above, the operating statements for IAWC's respective districts are approved as shown in the Appendices attached hereto.

VI. COST OF CAPITAL AND RATE OF RETURN

A. Capital Structure

For purposes of determining revenue requirement in this proceeding, IAWC proposes a forecasted 2010 capital structure consisting of 0.15% short-term debt, 51.22% long-term debt and 48.63% common equity. (IAWC Initial Brief at 73; IAWC Ex. 4.01SR; Tr. at 297-98, 324-25) As discussed below, the AG and IIWC recommend the IAWC's capital structure should include a higher percentage of short-term debt than is proposed by IAWC.

1. Intervenors' Positions

The AG contends that the Commission should adopt a capital structure with 3.26% short-term debt as recommended by AG/JM witness Ralph Smith and as shown on AG/JM Ex. 5.1, Sch. D. (AG Initial Brief at 49) Municipalities Homer Glen et al. concur in the AG's position. (Homer Glen Initial Brief at 15-16)

According to the AG, the record is clear that IAWC regularly uses short-term debt whenever there is a shortfall in revenues relative to expenses. (AG Initial Brief at 48; Tr. at 303) It uses short-term debt to fund cash working capital and to provide a bridge when other debt sources are delayed. In fact, during the course of this docket, IAWC witness Scott Rungren said that at least four different long-term debt financings were not issued when expected. Low cost, short-term debt financing gives the Company the flexibility to handle situations where long-term debt issuances fail to market, debt becomes due unexpectedly, or falling interest rates make it prudent to time debt issuances. Among the debt that was delayed was a $39 million planned debt, of which only $14 million was issued on December 4, 2009. The remaining $25 million was rescheduled to May, 2010, and will be treated as short-term debt until it gets reissued as long-term debt.

Although the amount of short-term debt varies over the course of a year, it is unreasonable and unrealistic to assume, as IAWC would have the Commission do, that IAWC will have virtually no short-term debt during the 2010 test year. It is already apparent that IAWC will have $25 million of short-term debt pending the May 2010 issuance of long-term debt for the remainder of the planned $39 million debt. This amount, without regard to other short-term debt needs, exceeds the 3.26% of short-term debt that AG/JM witness Smith recommends should be included in IAWC's capital structure. (AG Initial Brief at 49)

As shown on AG/JM Exhibit 5.1, Schedule D, Mr. Smith recommended a capital structure consisting of 3.26% short-term debt, 51.22% long-term debt, and 45.52% common equity, essentially shifting 3.11% of IAWC's forecasted capitalization from common equity to short-term debt. (AG/JM Ex. 5.0 at 16)

For the period 2004-2009, the Company's common equity ratio was less than 45%, and fairly stable until it proposed its projected 2010 capital structure in this case. (IIWC Ex. 1.0 at 11).

IIWC also takes issue with the Company's forecasted capital structure. (IIWC Initial Brief at 21-24; IIWC Ex. 1.0 at 10-12; IIWC Ex. 3.0 at 17-20) The Company's proposed 2010 capital structure reflects considerably less short-term debt and more common equity than has actually been used by the Company to finance utility assets over the period 2004 to 2009, and this "overstated" common equity component will increase cost of service. The projected capital structure reflects a $28 million equity infusion from the Company's parent, American Water Works, in May of 2009 and projected infusions of $8 million in December 2009, and $20 million in May of 2010. In IIWC's view, it is uncertain as to whether or not the projected equity infusions will occur and, therefore, the Company's projected capital structure is not known and measurable and should not be used for rate setting purposes in this case.

Because of its concerns about the Company's 2010 capital structure, IIWC proposed a capital structure from the Company's 2008 historical test year consisting of

52.24% long-term debt, 2.83% short-term debt and common equity of 44.94%. (IIWC Ex. 1.0 at 12, Table 3)

American Water Works and its subsidiary, American Water Works Capital Company, provide all external capital to IAWC, except in the case of tax-exempt bonds issued by local governments. Therefore, the Company's bond rating is tied to the financial risk of its parent, American Water Works, and American Water Works Capital Company. American Water Works' capital structure is not projected to have an increased common equity ratio and therefore, its bond rating will not be improved by the claimed reduced financial risk of the Company. Further, IIWC asserts, the Company will not have improved access to capital with the more expensive capital structure relative to its test year actual capital structure. In IIWC's view, the Company has identified no legitimate reason for using a forecasted capital structure to set rates that are substantially different from that of its parent company's actual capital structure. (IIWC Ex. 3.0 at 19)

According to IIWC, IAWC did not demonstrate the reasonableness of its forecasted increase in the common equity ratio, and its forecasted capital structure should be rejected. (IIWC Initial Brief at 22-23)

2. Staff's Position

The Staff witness did not take exception to the capital structure that contains 0.15% short-term debt, 51.22% long-term debt and 48.63% common equity, as proposed by IAWC. (Staff Initial Brief at 17-18; Staff Ex. 10.0 at 2)

According to Staff, capital structure affects the value of a firm and, therefore, its cost of capital, to the extent it affects the expected level of cash flows that accrue to parties other than debt and stock holders. (Staff Ex. 3.0 at 4) Employing debt as a source of capital reduces a company's income taxes, thereby reducing the cost of capital; however, as reliance on debt as a source of capital increases, so does the probability of default. As the probability of default rises, expected payments to attorneys, trustees, and other outside parties increase. Further, the expected cash flows decline as the company foregoes investment that would have been available to it had its financial condition been stronger, including the expected value of the income tax shield from debt financing. Beyond a certain point, a growing dependence on debt as a source of funds increases the overall cost of capital. Therefore, the Commission should not determine the overall rate of return from a utility's actual capital structure if the Commission concludes that capital structure adversely affects the overall cost of capital.

An optimal capital structure would minimize the cost of capital and maintain a utility's financial integrity. Unfortunately, determining whether a capital structure is optimal remains problematic because: (1) the cost of capital is a continuous function of the capital structure, rendering its precise measurement along each segment of the range of possible capital structures problematic; (2) the optimal capital structure is a function of operating risk, which is dynamic; and (3) the relative costs of the different types of capital vary with dynamic market conditions. (Staff Ex. 3.0 at 4-5) Consequently, one should determine whether the capital structure is consistent with the financial strength necessary to access the capital markets under most economic conditions; and, if so, whether the cost of that financial strength is reasonable. (Staff Initial Brief at 18)

3. IAWC's Position

As noted above, IAWC proposes a forecasted 2010 capital structure consisting of 0.15% short-term debt, 51.22% long-term debt and 48.63% common equity. In its Initial and Reply Briefs, IAWC asserts that its proposed short-term debt ratio is appropriate. (IAWC Initial Brief at 78-80; Reply Brief at 60-61)

The AG and the Municipalities recommend that IAWC switch 3.26% of its capitalization from common equity to short-term debt, asserting that short-term debt financing is more cost-effective. The AG's recommendation is improper, in IAWC's judgment, because it views the short-term debt component of the capital structure in isolation and ignores the fact that IAWC must maintain a balanced capital structure overall in order to obtain capital on reasonable terms. As a public utility, IAWC is required to maintain the ability to obtain capital on reasonable terms in order to provide adequate and reliable service in all economic conditions. Thus, it is essential that IAWC maintain a capital structure that will allow it to attract necessary capital in the market; IAWC must ensure that it is able, in all possible economic conditions, to attract debt and equity capital at the lowest weighted average cost of capital. This requires that IAWC maintain a balanced capital structure and a favorable rating for debt. (IAWC Reply Brief at 60; IAWC Ex. 20.00SR at 2-3)

Moreover, short-term debt is largely a function of construction expenditures and the timing of long-term financings, and IAWC's construction expenditures will be lower in 2010 than in 2008-2009. (IAWC Ex. 4.00SR at 9) In addition, IAWC's planned financings are designed to maintain a reasonable debt/equity mix. Thus, IAWC requires less short-term debt in its capital structure in 2010 than it did in 2008 or 2009, IAWC asserts.

In IAWC's view, the AG and the Municipalities focus incorrectly on the cost of common equity in isolation, rather than on the combined cost of capital (debt and equity) that results from a given capital structure, thereby ignoring the high risk associated with financing long-term investments with short-term debt, which can result in a rapid and unnecessary rise in costs to ratepayers. When short-term debt comes due, IAWC must secure replacement financing or else it runs the risk of not being able to meet its short-term debt obligations. This risk is known as liquidity risk.

The other risk inherent with a strategy of using short-term borrowing to finance long-term assets is interest rate risk, which is the risk that rates will rise above the level at which IAWC could have initially obtained long-term financing. When capital markets face distress, as they did in late 2008, access to short-term debt is restricted and rates rise rapidly. Additionally, if IAWC is forced to replace such short-term debt with long-term financing during economic crises, it will do so at significantly higher credit spreads and lock in high costs of financing. (IAWC Ex. 20.00SR at 13-14)

According to IAWC, short-term debt is an acceptable source of financing for short-term investments (that is an investment which will mature in less than one year), or as temporary financing until long-term debt or equity can be issued. However, the vast majority of IAWC's investments are long-term in nature. The recent economic crisis highlights the risks of financing long-term investments with short-term debt, as many companies that pursued this strategy required government bailout or faced severe financial distress. (IAWC Ex. 20.00SR at 13-14) For this reason, IAWC asserts, and given the desire to have fixed, predictable financial commitments, it is generally prudent to finance long-lived assets with long-term capital. (IAWC Ex. 20.00SR at 12-13)

In response to IIWC, the Company argues that its common equity ratio is appropriate. (IAWC Initial Brief at 80-84; Reply Brief at 62-65)

IAWC is responsible for raising debt capital on its own behalf. (IAWC Ex. 20.00SR at 2, 8) IAWC has the ability to issue debt capital on its own through public or private issuances. Under an affiliated interest agreement approved by the Commission in Docket No. 04-0852, IAWC also has the ability to issue both short- and long-term debt through American Water Capital Corp. ("AWCC"), provided that AWCC is determined to be the least cost source of debt capital. If AWCC is unable or unwilling to provide the lowest cost debt financing, IAWC must independently access the debt markets via public or private debt issues.

To date, IAWC has not chosen to obtain debt capital through public issuances due to the higher issuance costs related to such placements. (IAWC Ex. 20.00SR at 2) Thus, IAWC has not been required to obtain an agency rating for its bonds, and as such, does not have a stand-alone bond rating. IAWC has, however, issued debt through private offerings, primarily to institutional investors. Although these offerings (unlike public offerings) do not require a "bond rating," the private investor in effect assigns its own "rating," developed in a manner similar to that used by the rating agencies for public debt. IAWC must therefore maintain a certain rating in order to issue capital on reasonable terms as it is required to maintain adequate and reliable service. (Id.) This requires that IAWC maintain a balanced capital structure. As a result, IAWC's capital structure and cash flows should be designed to maintain at least a BBB+ credit rating, and the proposed common equity ratio of 48.63% would provide an opportunity to obtain a BBB+ rating if IAWC were rated by S&P. (IAWC Reply Brief at 62-63; IAWC Ex. 20.00SR at 4)

IAWC's common equity ratio is consistent with that of other comparable utilities. IAWC examined the average common equity ratios of the two proxy groups of utility companies discussed in the direct testimony of IAWC witness Pauline Ahern. (IAWC Initial Brief at 76-77; Reply Brief at 63) For the year ended 2007, the average common equity ratio of Ms. Ahern's proxy group of six AUS Utility Reports water companies was

49.45%, with a standard deviation of 4.16%. For the same period, the average common equity ratio of Ms. Ahern's 26 utility company sample was 44.54%, with a standard deviation of 6.67%. Thus, IAWC's forecasted average common equity ratio for the 12-month period ending December 31, 2010 of 48.63% is within one standard deviation of the average common equity ratio of both Ms. Ahern's six AUS Utility Reports water companies and her 26 utility-company sample. (IAWC Ex. 4.00 at 10-11; IAWC Ex. 4.00R1 at 2)

To further check the reasonableness of the proposed capital structure, Mr. Rungren also considered projected common equity ratios from Value Line Investment Survey. (IAWC Ex. 4.00 at 11) Value Line estimates that the composite common equity ratio for the water utility industry will be 48.0% in 2008, 49.0% in 2009, 50.0% in 2010, and 50% over the 2012-2014 time period. Thus, IAWC's pro-forma average common equity ratio for the 12-month period ending December 31, 2010 is also relatively close to Value Line's projected common equity ratios for the water utility industry, IAWC asserts.

In IAWC's view, IIWC witness Mr. Gorman's own proxy groups' data supports the reasonableness of IAWC's proposed capital structure. (IAWC Reply Brief at 64) The average common equity ratios of the companies in Mr. Gorman's 3 proxy groups – Water Utility, Gas Utility, and Electric Utility – range from 44.60% to 53.90% (by AUS measurement) and 47.10% to 55.50% (by Value Line projection). (IAWC Reply Brief at 64, citing IIWC Exhibit 1.3) According to IAWC, if Mr. Gorman relied on these samples to compute his recommended cost of common equity in this proceeding, he must consider these groups to be reasonably well-suited for comparison with IAWC. Moreover, IAWC's test year common equity ratio of 48.63% is consistent with, and compares favorably with, these industry averages. (IAWC Ex. 4.00SR at. 11-12)

In further response to IIWC, the Company asserts that American Water is not required to invest in the common equity capital of IAWC or any other specific entity, but has supported IAWC in its effort to maintain a balanced capital structure in the past and intends to do so in the future, subject to evaluation of IAWC's risk and reward profile. (IAWC Ex. 20.00SR at 5-6)

IAWC says IIWC also contends that IAWC should have a capital structure similar to that of American Water because IAWC's bond rating is tied to the financial risk represented by American Water. In response, IAWC asserts that its operating risk profile is significantly different than the risk profile of American Water. American Water makes common equity investments in water and water-related businesses, including regulated utilities, in many different states, while IAWC is a regulated water utility operating in the state of Illinois. Since the appropriate capital structure of a business should reflect the risk profile of such business' operations, it is reasonable to expect that the capital structure of IAWC and American Water would differ. (IAWC Reply Brief at 82)

IAWC further argues that it must maintain a financial position to attract capital in all possible economic circumstances, irrespective of the capital structure of American Water. (IAWC Reply Brief at 65) If IAWC obtained a credit rating, it would be significantly lower than American Water's/AWCC's BBB+ rating in IAWC's view. Therefore, the added cost of obtaining and maintaining a credit rating for IAWC would be unnecessary, especially since it is not a regular issuer of debt, and the minimum cost to rate a company is only appropriate if there is a reasonable expectation to gain a materially higher credit rating. (IAWC Ex. 20.00SR at 7) In addition, the historical returns earned by American Water on its common equity investments in IAWC are well below the "theoretical" return allowed in previous rate cases. IAWC argues that it must improve its credit ratios to maintain access to debt and equity capital markets.

4. Commission Conclusion

IAWC proposes a forecasted 2010 capital structure consisting of 51.22% long-term debt, 0.15% short-term debt, and 48.63% common equity. IAWC's proposal is also supported by Staff. IIWC proposes a capital structure consisting of 52.24% long-term debt, 2.83% short-term debt, and 44.94% common equity, which was based on IAWC's December 31, 2008 capital structure. AG/JM recommended a capital structure consisting of 51.22% long-term debt, 3.26% short-term debt, and 45.52% common equity.

It is important to remember why a test year is utilized in the ratemaking process. Generally speaking, the test year is utilized so that revenues and expenses are matched relatively well for the period when rates will be in effect. The Commission is concerned that IAWC's forecast capital structure for 2010 may not be not representative of what it has been in the past or what it will be in future periods when rates set in this proceeding are in effect. In other words, the Commission believes that IAWC's forecasted test year capital structure for the capital structure, while arguably reasonable for that year, may not be sufficiently representative of IAWC's typical capital structure. The Commission notes that in Docket No. 07-0507 the approved capital structure for IAWC was comprised of 52.97% long-term debt, 3.26% short-term debt, and 43.77% common equity.

The Commission finds that IAWC's capital structure should include more short-term debt than that the 0.15% it has proposed. As Intervenors have observed, when short-term debt is the least expensive component of capital, ratepayers will pay a higher return if the percentage of short-term debt is too low, since the overall cost of capital is used to calculate return on rate base. The Commission believes that the proportion recommended by IAWC witness, Mr. Gorman, 2.83% is appropriate for purposes of this proceeding. Increasing the short-term will require that other components be reduced in some manner. The Commission believes it is appropriate to reduce IAWC's long-term debt and common equity percentage in proportion to the amounts that IAWC projects for 2010. This produces a capital structure comprised of 49.84% long-term debt, 2.83% short-term debt, and 47.33% common equity, which the Commission finds to be reasonable.

B. Cost of Debt

1. Cost of Short-Term Debt

IAWC's average projected cost of short-term debt for the 2010 test-year is 1.97%. (IAWC Initial Brief at 84; IAWC Ex. 4.00R1at 2) IAWC proposes to use this rate in calculating its cost of capital in this case.

The AG recommends a cost of short-term debt at the "current rate." (AG Initial Brief at 47) The AG says the IAWC witness testified that actual cost of short-term debt for November 2009 was 0.3437% (Tr. at 320); the AG asserts that this rate should be used. (AG Initial Brief at 49; Reply Brief at 31)

IIWC witness Mr. Gorman proposed to use a short-term debt cost of 1.0% instead of the Company's 1.97%. (IIWC Ex. 1.0 at 14) He said the Company's proposal did not appear to reflect a significant decline in short-term interest rates, and that through the second quarter of 2009, Illinois-American's Annual Report indicates its actual embedded interest rate was 0.92%. IIWC also notes testimony by an IAWC witness that if the Commission determines to use the Company's actual cost of short-term debt in the weighted average cost of capital calculation, it should use the Company's actual cost of short-term debt as of September 2009, which was 0.4634%. (IIWC Initial Brief at 20-21)

Commission Staff witness Ms. Kight-Garlisch disagreed with IAWC's use of forecasted interest rates to determine the cost of short-tem debt as a matter of sound financial principle. (Staff Ex. 10.0 at 2-3) Nonetheless, in this case, because using forecasted interest rates do not change the overall cost of capital for IAWC since the amount of short-term debt in the IAWC-proposed capital structure is so small, Staff accepted IAWC's proposed cost of short-term debt. (Id.) The witness explained that using Staff's proposed 1.0% interest rate or either of the Company's proposed 1.97% interest rate or its alternative of 0.4634% is so small that it does not change the overall cost of capital. (Staff Initial Brief at 19)

2. Cost of Long-term Debt

Long-term debt comprises 51.22% of IAWC's proposed capital structure. IAWC's initial projection of the cost of long-term debt was 6.77%. (Schedule D-3, p. 1) Based on lower actual and projected interest rates, IAWC subsequently revised this cost to 6.53% (IAWC Ex. 4.00SUPP at 3), and then to 6.28% (IAWC Ex. 4.00R1 at 4). IAWC states that AG witness Smith accepted IAWC's proposed cost of long-term debt, as did IIWC witness Gorman. (AG/JM Ex. 5.0 at 6; IIWC Ex. 3.0 at 25)

IAWC had projected an issuance of debt in November 2009, at an estimated interest rate of 6.64%. However, $14 million of that debt was issued in December 2009, at an interest rate of 6.00%, with the rest to be issued in May 2010 (at a projected rate of 6.20%). (Tr. 297-98, 324-25) Given the debt issuance at 6.00%, which occurred just prior to the hearing in this proceeding, IAWC in turn accepted Staff's projected overall embedded cost of long-term debt of 6.24%. (IAWC Initial Brief at 84-85; Reply Brief at 66; Tr. at 324-325)

3. Commission Conclusion

With respect to the cost of short-term debt, IAWC proposes to use its average projected cost of short-term debt for the 2010 test-year, 1.97%. The AG recommends a cost of short-term debt at the "current rate," 0.3437%, for purposes of setting rates. IIWC proposes using a short-term debt cost of 1.0%. Staff's witness estimated the cost of short-term debt to be 1.0% but because the IAWC-proposed proportion of short-term debt is so small, Staff did not object to using IAWC's propose cost of short-term debt.

The cost of short-term debt calculated by Staff witness Kight-Garlisch, 0.9961%, and IIWC witness Gorman, 1.0%, are essentially the same and, in the Commission's view, the most reasonable cost rate proposed by any witness. The method used by Staff witness Kight-Garlisch is consistent with the method typically adopted by the Commission. Even though Staff does not object to the IAWC's proposed cost of short-term debt, the Commission concludes that for purposes of setting rates in this proceeding, a cost rate of 1.0% is reasonable and should be used.

The cost of long-term debt, while subject to several proposed revisions, does not appear to be a point of disagreement. Staff was the last party to make a recommendation regarding the cost of long-term debt, a proposed cost rate of 6.24%. IAWC accepted that proposed cost rate and neither the AG nor IIWC appear to recommend a rate different than that proposal. For purposes of establishing rates in this proceeding, the Commission finds Staff's proposed cost rate for long-term debt, 6.24%, to be reasonable and it is hereby adopted.

C. Cost of Common Equity

As discussed below, IAWC, Staff, IIWC, and CUB recommend returns on common equity of 10.90%, 10.38%, 10.0%, and 7.44%, respectively.

1. IAWC's Position

IAWC presented the testimony of Ms. Pauline Ahern, a Principal with AUS Consultants, to analyze IAWC's cost of common equity. Ms. Ahern's final recommendation of a reasonable rate of return is a range of 10.70%-11.10% (IAWC Ex. 8.00SR Rev. at 18-19). IAWC has selected the midpoint of this range, 10.90%, as a reasonable common equity cost rate. (IAWC Initial Brief at 85-87; IAWC Ex. 4.00SR at 1)

Ms. Ahern's recommendation is based on an assessment of market-based cost rates of publicly-traded companies of relatively similar risk: a proxy group of 6 water companies, and a separate group of 26 utility companies, as well as her review and adjustment of the proposals of Staff witness McNally, IIWC witness Gorman, and CUB witness Thomas. As Ms. Ahern states in her surrebuttal testimony, having reviewed all of these data, she finds that a range of common equity cost rates of 10.70%-11.10%, with a midpoint of 10.90%, is not in excess of a reasonable rate of return.

For her initial analysis, Ms. Ahern applied two well-tested market-based cost of common equity models to these data – the single-stage growth Discounted Cash Flow ("DCF") Model and the Capital Asset Pricing Model ("CAPM"). According to IAWC, these models are ones the Commission has generally relied on in prior proceedings, including Docket Nos. 03-0403, 04-0442, 05-0071/05-0072 (Cons.), 06-0285, and 07-0507. (IAWC Initial Brief at 86; IAWC Ex. 8.00 Rev. at 6) To synthesize the cost rates generated by each model, Ms. Ahern averaged the predicted cost rates generated by each model, giving twice as much weight to the rates predicted for the six-utility company proxy group because all members of this proxy group are engaged in the same service – provision of water-utility services – as is IAWC. This resulted in a baseline cost rate of 11.80%.

As Ms. Ahern discusses, using other utilities of relatively comparable risk as proxies is consistent with the principles of fair rate of return (as established in Federal Power Comm'n v. Hope Natural Gas Co., 320 U.S. 591 (1944) and Bluefield Water Works & Improvement Co. v. Public Service Comm'n, 262 U.S. 679 (1923)) and adds reliability to the informed expert judgment used in arriving at a recommended common equity cost rate. However, in her judgment, no proxy group can be selected to be identical in risk to IAWC and therefore, the proxy groups' results must be adjusted to reflect differences in business and financial risk profiles as discussed below. (IAWC Ex. 8.00 Rev. at 5)

In Section IV.C.2 of its Initial Brief, IAWC argues, "IAWC's Return on Common Equity Must Be Adjusted for Business Risk." (IAWC Initial Brief at 87-89)

Business risk incorporates all of the risks of a firm other than financial risk, which is discussed below. Examples of business risk include the quality of management, the regulatory environment, customer mix and service territory growth, which have a direct bearing on earnings. It is investors' perception of the risk associated with investment in a given utility's common equity that is relevant to estimating the cost of common equity capital. This perception can be assessed, in part, by reviewing information of the type that investors consider with regard to the risk faced by the specific utility involved in the industry in which it operates. Business risk is important to the determination of a fair rate of return because the greater the perceived level of risk, the greater the rate of return investors demand, consistent with the basic financial precept of risk and return. (IAWC Ex. 8.00 Rev. at 9)

As Ms. Ahern explains, the water and wastewater utility industry faces significant risks related to replacing aging transmission and distribution systems. In addition, because the water and wastewater industry is much more capital-intensive than the electric, natural gas or telephone industries, the investment required to produce a dollar of revenue is greater. According to IAWC, the National Association of Regulatory Commissioners ("NARUC") has highlighted the challenges facing the water and wastewater industry stemming from its capital-intensive nature. IAWC itself is facing an expected "massive capital investment" as it projects gross capital expenditures of $469.319 million for the years 2008 through 2013, representing an increase of 45% over 2007 gross plant of $1.044 billion. (IAWC Ex. 8.00 at 9-11)

IAWC states that both the Congressional Budgeting Office ("CBO") and the Environmental Protection Agency ("EPA") have addressed the necessary future growth in water and wastewater utility infrastructure. Lastly, the water utility industry, as well as the electric and natural gas utility industries, faces the need for increased funds to finance the increasing security costs required to protect the water supply and infrastructure from potential terrorist attacks in the post-September 11, 2001 world. (Id. at 13-14)

The water and wastewater utility industry, IAWC contends, also experiences relatively lower depreciation rates. Lower depreciation rates, as one of the principal sources of internal cash flows for all utilities, mean that water and wastewater utility depreciation as a source of internally-generated cash is far less than for electric, natural gas or telephone utilities. Water and wastewater utilities' assets have longer lives and, hence, longer capital recovery periods. As such, IAWC claims water and wastewater utilities face greater risk due to inflation, which results in a higher replacement cost per dollar of net plant than for other types of utilities. (IAWC Initial Brief at 88; IAWC Ex. 8.00 Rev. at 11-12)

According to IAWC, it faces additional extraordinary business risk owing to several factors. IAWC's geographic spread necessitates compliance with a wide range of regulatory requirements in multiple, non-contiguous locations. The fact that it is distributing water (as opposed to energy) also requires regulatory compliance with environmental laws that energy utilities do not account for. Illinois itself has more stringent environmental regulations that impose higher costs of operation, and thereby increase business risk. IAWC faces increased business risk because of the source and quality of its water supply.

In IAWC's view, its concentration of sale-for-resale customers also increases its relative business risk, because these customers, who represent 20% of IAWC's sales, can choose to discontinue service whenever their contracts end. IAWC's smaller relative size makes it less able to cope with significant events which affect sales, revenues and earnings, such as the loss of revenue from a few larger customers or extreme weather conditions. Finally, IAWC's smaller size, and corresponding lower market capitalization, creates a market perception of increased risk as compared to the proxy group of 6 water companies, and the larger group of 26 utility companies. (IAWC Initial Brief at 89; IAWC Ex. 8.00 Rev. at 15-20)

To quantify this additional business risk, Ms. Ahern used data contained in the 2009 Yearbook – Valuation Edition. The determinations are based on the size premia for decile portfolios of New York Stock Exchange ("NYSE"), American Stock Exchange ("AMEX") and Nasdaq-listed companies for the 1926-2007 period, and on related data. Ms. Ahern adjusted the determinations to arrive at an "extremely conservative" business risk adjustment of 15 basis points. (IAWC Initial Brief at 89; IAWC Ex. 8.00 Rev. at 40-41)

In Section IV.C.3 of its Initial Brief, IAWC next argues, "IAWC's Return on Common Equity Must Be Adjusted for Financial Risk." (IAWC Initial Brief at 89-90)

According to IAWC, financial risk is the additional risk created by the introduction of senior capital, i.e., debt and preferred stock, into the capital structure. In other words, the higher the proportion of senior capital in the capital structure, the higher the financial risk. Standard & Poors ("S&P") bond or issue credit ratings may be used as an indicator of financial risk. Similar bond ratings/issue credit ratings reflect similar combined business risks, i.e., total risk. Although the specific business or financial risks may differ between companies, IAWC says the same bond rating indicates that the combined risks are similar as the bond rating process reflects acknowledgment of all diversifiable business and financial risks in order to assess credit quality or credit risk. (IAWC Ex. 8.00 Rev. at 20-22)

Ms. Ahern used predicted S&P and Moody's Investors Service ("Moody's") bond ratings for IAWC's long-term debt as a measure of the financial risk represented by IAWC. She determined that IAWC would be rated at the bottom of the BBB/Baa or the top of the BB/Ba bond rating categories. She also estimated that IAWC's likely S&P credit rating would be at the bottom of the BBB or top of the BB credit rating category. (Id. at 41-42) In contrast, the average S&P and Moody's bond and/or credit ratings of the proxy groups are in the A bond/credit rating category. Therefore, IAWC has greater financial risk than the average company in either proxy group, and would therefore require an upward adjustment to its cost of common equity, in IAWC's view.

Ms. Ahern used the bond yield differential between Moody's A and Baa rated public utility bonds to compute the required financial risk adjustment. Rather than relying on the recent 151-point yield differential between Moody's A and Baa rated public utility bonds, which is significantly higher than historical averages, Ms. Ahern based her estimate on the normalized yields differential of approximately 30 basis points over the most recent 20-year historical period. This also represents a conservative adjustment, not just because it is significantly different from the 151-point recent differential, but also because this is the yield differential between the middle of the A and Baa bond rating categories, while IAWC's debt would likely have a low Baa or high Ba bond rating if they were rated by Moody's (resulting in a larger than 30-point differential). (Id. at 42-43.)

Application of the adjustments for business and financial risk resulted in an initial recommendation of a 12.25% cost rate. (IAWC Initial Brief at 87) A final recommendation was made after by Ms. Ahern after reviewing the testimony of Staff and Intervenors. In this regard, IAWC notes that IIWC's recommendation, after IAWC "corrections," has a midpoint of 11.05%, and an average of 10.92%, and that in rebuttal, AG witness Smith uses a cost rate of 10.19%, which is an average of the "uncorrected" Staff and IIWC recommendations. (AG/JM Ex. 5.1 at 8; Schedule D)

After reviewing the testimony of Staff and Intervenors, Ms. Ahern found that a range of common equity cost rates of 10.70%-11.10%, with a midpoint of 10.90%, is not in excess of a reasonable rate of return. (IAWC Initial Brief at 87, 104-105) IAWC has, therefore, selected the midpoint of this range, 10.90%, as an appropriate and reasonable common equity cost rate. Based upon a common equity cost rate of 10.90%, IAWC's updated weighted average cost of capital for the 2010 average test year is 8.50%. This reflects the overall cost of long-term debt of 6.24%, recommended by Staff and accepted by IAWC. (Tr. at 297-98, 324-25)

2. Staff's Position

Staff witness Michael McNally estimated IAWC's investor-required rate of return on common equity to be 10.38%. (Staff Ex. 4.0 at 29) Mr. McNally measured the investor-required rate of return on common equity using discounted cash flow and Capital Asset Pricing Model analyses. Mr. McNally applied those models to a sample of water utility companies ("Water Group") and a sample of comparable public utility companies ("Utility Group"). (Id. at 2)

To select the companies in the Water Group, Mr. McNally started with a list of publicly traded, domestic water utilities included in S&P Utility Compustat. He then eliminated any company that: (1) reduced its dividend or does not consistently pay a dividend; (2) did not have a Zacks Investment Research ("Zacks") 3-5 year growth rate; or (3) did not have five years of pricing data available from which beta could be calculated. The eight remaining companies compose the Water Group.

The companies in the Utility Group were chosen on the basis of a principal components analysis using 12 financial and operating ratios: (1) common equity to capitalization; (2) funds from operations to capitalization; (3) funds from operations to long-term debt; (4) fixed assets to revenues; (5) free cash flow to capitalization; (6) funds from operations interest coverage; (7) net cash flow to capital expenditures; (8) net plant to capital expenditures; (9) operating profit margin; (10) operating revenue stability; (11) earnings before interest and taxes stability; and (12) earnings stability.

For the first nine ratios, data from the period 2006-2008 were averaged to normalize the ratios. The last three ratios were measured over the period 2004-2008 with the coefficient of determination of a least squares regression of the natural logarithm of the respective quarterly data against time. After calculating the scores for each principal component, he rank-ordered the companies in terms of least relative distance from IAWC's target scores. He then eliminated: (1) water utilities to avoid doubling the weight given them, as they were already considered in his Water Group;

(2) any non-investment grade utilities; (3) any company that reduced its dividend or does not consistently pay a dividend; and (4) any company that lacked a Zacks 3-5 year growth rate. The Utility Group consisted of the five utilities the least distance from, and therefore, the most comparable to, IAWC.

For reasons summarized below, Mr. McNally's 10.38% cost of equity recommendation for IAWC is based on the results of his Utility Group analyses. (Id. at 29)

As indicated above, Mr. McNally performed DCF and CAPM analyses. A DCF analysis assumes that the market value of common stock equals the present value of the expected stream of future dividend payments. Since a DCF model incorporates time-sensitive valuation factors, it must correctly reflect the timing of the dividend payments that stock prices embody. The companies in Mr. McNally's samples pay dividends quarterly. Therefore, Mr. McNally applied a quarterly DCF model. (Staff Ex. 4.0 at 5-6)

Mr. McNally employed a multi-stage, non-constant DCF model ("NCDCF") in his DCF analysis. Mr. McNally explained that, in choosing the appropriate DCF model, the measurement error of the NCDCF must be weighed against that of the constant growth DCF. While an NCDCF model is a more elaborate model with additional unobservable growth rate variables that are likely subject to greater measurement error than the analyst growth rate estimates Staff uses in constant growth DCF analyses, the cost of common equity estimate derived from a constant growth DCF model is appropriate to use only if the near-term growth rate forecast for each company in the sample is expected to equal its average long-term dividend growth.

In this case, the expected near-term growth levels for the Water Group (8.08%) and the Utility Group (5.18%) were, respectively, approximately 80% and 15% greater than the expected long-term growth of the overall economy, as measured by GDP growth (approximately 4.5%). Mr. McNally believes that no company could sustain a growth rate greater than that of the overall economy, or it would eventually grow to the size of the economy of which it is only a part. Moreover, since utilities in particular are generally below-average growth companies, the sustainability of an above average growth rate is particularly dubious. Thus, given the substantial difference between the near-term growth rates for the samples and the overall growth of the economy, the continuous sustainability of the near-term growth rates for those samples is highly unlikely, in the Staff witness' view. Therefore, Mr. McNally concluded that the measurement error associated with a constant-growth DCF analysis exceeds that associated with an NCDCF model, making the latter model preferable.

Mr. McNally's NCDCF model incorporated three stages of dividend growth. The first, a near-term growth stage, is assumed to last five years. For this stage, Mr. McNally used Zacks growth rate estimates as of September 2, 2009. The second stage is a transitional growth period that spans from the beginning of the sixth year through the end of the 10th year. The growth rate employed in the transitional growth period equals the average of the Zacks growth rate and the "steady-state" stage growth rate. Finally, the third, or "steady-state," growth stage commences at the end of the 10th year and is assumed to last into perpetuity. For this stage, Mr. McNally utilized the implied 20-year forward U.S. Treasury rate in 10 years, which reflects current expectations of the long-term overall economic growth during the steady-state growth stage of his NCDCF model. An implied 20-year forward U.S. Treasury rate in 10 years of 4.54% was derived from the 3.29% 10-year and the 4.09% 30-year U.S. Treasury rates as of September 2, 2009.

An expected stream of dividends was then estimated by applying the growth rate estimates for those three stages to the September 2, 2009 dividend. The discount rate that equates the present value of this expected stream of cash flows to the company's September 2, 2009 stock price equals the market-required return on common equity. Based on this growth, stock price, and dividend data, Mr. McNally's DCF estimates of the cost of common equity were 9.30% for the Water Group and 10.72% for the Utility Group. (Staff Initial Brief at 23)

As noted above, Mr. McNally also performed a CAPM analysis. According to financial theory, the required rate of return for a given security equals the risk-free rate of return plus a risk premium associated with that security. The risk premium methodology is consistent with the theory that investors are risk-averse and that, in equilibrium, two securities with equal quantities of risk have equal required rates of return. Mr. McNally used a one-factor risk premium model, the Capital Asset Pricing Model, to estimate the cost of common equity. In the CAPM, the risk factor is market risk, which cannot be eliminated through portfolio diversification. (Staff Ex. 4.0 at 12-13)

The CAPM requires the estimation of three parameters: beta, the risk-free rate, and the required rate of return on the market. For the beta parameter, Mr. McNally combined adjusted betas from Value Line, Zacks, and a regression analysis. The average Value Line, Zacks, and regression beta estimates were 0.76, 0.63, and 0.57, respectively. The Value Line regression employs 259 weekly observations of stock return data regressed against the NYSE Composite Index. Both the regression beta and Zacks betas employ 60 monthly observations; however, while Zacks betas regress stock returns against the S&P 500 Index, the regression beta regresses stock returns against the NYSE Index. Since the Zacks beta estimate and the regression beta estimate are calculated using monthly data rather than weekly data (as Value Line uses), Mr. McNally averaged the monthly data beta results to avoid over-weighting that approach. He then averaged that result with the Value Line beta, which produced a beta for the Gas Group of 0.68.

For the risk-free rate parameter, Mr. McNally considered the 0.09% yield on four-week U.S. Treasury bills and the 4.13% yield on 30-year U.S. Treasury bonds. Both estimates were measured as of September 2, 2009. Forecasts of long-term inflation and the real risk-free rate imply that the long-term risk-free rate is between 4.3% and 5.2%. Thus, Mr. McNally concluded that the U.S. Treasury bond yield is currently the superior proxy for the long-term risk-free rate. (Id. at 13-17) Finally, for the expected rate of return on the market parameter, Mr. McNally conducted a DCF analysis on the firms composing the S&P 500 Index. That analysis estimated that the expected rate of return on the market equals 12.70%. Inputting those three parameters into the CAPM, Mr. McNally calculated cost of common equity estimates of 9.96% for the Water Group and 10.04% for the Utility Group. (Id. at 24)

Based on his DCF and risk premium models, Mr. McNally estimated that the cost of common equity for the Water Group is 9.63% and the cost of common equity for the Utility Group is 10.38%. Mr. McNally then compared the risk of the two samples to IAWC to determine the relative weighting that should be applied to each. (Staff Ex. 4.0 at 25)

Mr. McNally used two approaches to determine the relative weighting that should be applied to each of his samples. The first approach involved a review of S&P credit ratings. The average S&P credit rating for the companies in his Water Group is A, while the average S&P credit rating for the companies in his Utility Group is BBB, which indicates that the Water Group is less risky than the Utility Group. Although S&P does not present a credit rating specifically for IAWC, IAWC's affiliates for which S&P does present credit ratings, including its parent and regulated sister subsidiaries, are all rated BBB+. Thus, S&P credit ratings for IAWC's parent and affiliate companies suggest that IAWC may be riskier than the Water Group, but slightly less risky than the Utility Group.

The second approach Mr. McNally used to determine the relative risk of his samples to IAWC was to perform a principal components analysis, using the same approach used to select his Utility Group. He compared four principal components factor scores for IAWC, his Water Group, and his Utility Group to assess their relative risk. Each utility's principal components factor score represents the number of standard deviations that utility falls from the industry average in terms of that specific risk factor.

Factor 1 measures financial strength, with a higher score indicating less risk. Factor 2 measures construction risk, with a higher score again indicating less risk. Factor 3 measures revenue and earnings stability, indicators of sales and cost variability. A higher factor 3 score indicates greater revenue and earnings stability and, thus, lower risk. Factor 4 measures capital intensity. Capital intensity can insulate a company from competition and, thus, reduce risk, but can also indicate higher operating leverage (i.e., fixed costs), which can increase risk through lower earnings stability. Overall, Mr. McNally's principal components analysis indicates that IAWC has slightly higher risk than the Water Group and overall risk that is equal to or slightly greater than of the Utility Group. (Staff Initial Brief at 26-27; Staff Ex. 4.0 at 27-29)

Both Mr. McNally's review of credit ratings and his principal components analysis suggest that the Water Group is less risky than either IAWC or the Utility Group. However, the risk of IAWC relative to the Utility Group is less obvious. While the S&P credit ratings for IAWC's parent and affiliate companies suggest that IAWC may be slightly less risky than the Utility Group, the principal components scores suggest that it may be slightly more risky. Given the split results of those risk measures, the minor difference in risk each suggests, and the inexact nature of risk assessment, it is reasonable to conclude that the Utility Group's risk level is representative of that of IAWC. Thus, Mr. McNally estimated the cost of common equity for IAWC based on the results of the Utility Group, recommending a cost of common equity of 10.38%. (Staff Initial Brief at 28)

Mr. McNally also commented on Ms. Ahern's analysis of IAWC's cost of common equity. According to the Staff witness, the most significant flaws in Ms. Ahern's analysis are her use of a constant growth DCF model, which incorrectly assumes that the current 3-5 year growth rates for the companies in her samples are sustainable, and her addition of an unwarranted business risk adjustment to the results of her analyses. (Staff Initial Brief at 35-41; Staff Ex. 4.0 at 30-31) In Mr. McNally's opinion, the near-term growth rates for Ms. Ahern's samples, like those for Mr. McNally's samples, are not sustainable over the long term, based on current expectations of long-term economic growth. (Staff Ex. 4.0 at 31-32)

Regarding the business risk adjustment, the only basis Ms. Ahern presented for the quantification of her business risk adjustment, Staff asserts, is application of the findings of an Ibbotson study to the difference in size between the market values of her proxy groups and a hypothetical estimate of what IAWC's market value "would" allegedly be if it were traded. However, a size-based risk premium for a utility is contrary to financial theory and unsupported by empirical studies, in Mr. McNally's view. (Staff Ex. 4.0 at 33-35)

According to Mr. McNally, even if one accepts the Ibbotson study as proof of the general existence of a size premium, Ms. Ahern presented nothing to support her conclusion that a size premium is warranted for utility companies specifically. The Ibbotson study, which forms the basis of Ms. Ahern's business risk adjustment, is not restricted to utilities. Rather, it is based on the entire population of NYSE, American Stock Exchange ("AMEX"), and Nasdaq-listed securities, which are heavily weighted with industrial stocks. (IAWC Ex. 8.00 Rev., Schedule 8.01 at 6) Thus, in Mr. McNally's view, the entire quantitative basis of Ms. Ahern's business risk adjustment calculation is unfounded. (Staff Initial Brief at 39; Staff Ex. 4.0 at 33-35) In Staff's view, Ms. Ahern failed to establish that IAWC's business risk is any higher than that of the companies in her samples. (Staff Initial Brief at 40)

Staff also opposes IAWC's financial risk adjustment. (Staff Initial Brief at 32-33) Ms. Ahern's "financial risk" adjustment is based on her conclusion that there is a difference of "at least two notches or more" between the average credit rating of Mr. McNally's Utility Group and her presumed credit rating of IAWC. However, her claim that the average credit rating for the Utility Group is BBB+ and that, in her opinion, IAWC would be rated BBB-/BB+ if it were rated by S&P is based on flawed analysis, in Staff's view. Moreover, Mr. McNally's analysis of the risk of the IAWC relative to that of his Utility Sample, from which his cost of common equity estimate was derived, indicated that no such adjustment was necessary. (Staff Ex. 4.0 at. 26-29)

First, Ms. Ahern overstates the credit rating for Mr. McNally's Utility Group, Staff asserts. The average S&P corporate (i.e., issuer) credit rating for the companies in his Utility Group is BBB. However, Ms. Ahern based her "financial risk" adjustment on a BBB+ bond (i.e., issue) rating. An issuer credit rating represents the general risk and overall financial condition of a firm, as a whole. In contrast, a bond rating takes into consideration factors specific to a given issue or type of issue, such as guarantees or securitizations enhancing the credit of that particular obligation. Thus, since Ms. Ahern's adjustment is intended to reflect the risk of IAWC as a whole relative to that of the Utility Group, the BBB issuer credit rating would be the appropriate rating to use in this application. Moreover, since the S&P financial risk profile, the business risk profile, and the ratings matrix that form the basis for Ms. Ahern's hypothetical rating for IAWC, relate to issuer credit ratings, the BBB issuer credit rating should also be used for consistency in comparing the credit rating of the Utility Group to the hypothetical credit rating for IAWC. (Staff Ex. 11.0 at 5-6)

Second, Ms. Ahern underestimated the assumed credit rating for IAWC. Ms. Ahern's opinion of what IAWC would be rated, if it were rated by S&P, is inconsistent with published S&P opinions and with the S&P rating methodology she cites, which causes her to overstate both IAWC's financial and business risk profiles. To begin with, S&P has assigned an "Excellent" business risk profile to every single water utility that it rates, including six of the eight water utilities in Ms. Ahern's or Mr. McNally's water samples and the primary subsidiary of a seventh, as well IAWC's parent and two of its regulated sister subsidiaries. Ms. Ahern, however, simply assumed a "Strong" business risk profile for IAWC, an assumption she did not explain, much less support, in Mr. McNally's opinion. (Id. at pp. 6-7)

In addition, Ms. Ahern claims her review of S&P's updated benchmarks and IAWC's updated financial ratios supports her original estimate of IAWC's credit rating, if it were rated. (IAWC Ex. 8.00SR Rev. at 5) However, her claim is not supported by the document she cites, in Mr. McNally's view.

Ms. Ahern's financial risk adjustment is based on a comparison of the actual credit ratings for Mr. McNally's sample, which are derived from S&P's assessments of financial risk profile, to her estimate of IAWC's credit rating, which she derived from her assessment of the financial risk profile that focuses on three financial ratios. Staff claims Ms. Ahern did not, and cannot, demonstrate that the "Aggressive" to "Highly Leveraged" financial risk profile she assumes is what S&P would likely conclude, much less that S&P would assign IAWC an issuer and bond rating of BBB-/BB+. In fact, based on IAWC's updated financial ratios and S&P's updated methodology, two of the three ratios for IAWC fall squarely in the "Aggressive" benchmark range, with the third right at the boundary between the "Aggressive" and the "Highly Leveraged" categories, which suggests an "Aggressive" financial risk profile. Staff says all of the water companies S&P rates that have a financial risk profile of "Aggressive" to go with their "Excellent" business risk profile, were awarded S&P issuer ratings of BBB+ or A-. (IAWC Schedule 8.09R7 at 3) That is consistent with all of the analysis Mr. McNally has presented and supports his conclusion that no financial risk adjustment is warranted, in Staff's view. (Staff Initial Brief at 34-35)

Mr. McNally also replied to IAWC's criticisms of and suggested "corrections" to Mr. McNally's analyses. Staff responds to IAWC criticisms that, rather than using the then-current 30-year U.S. Treasury bond ("T-bond") yield to estimate the risk-free rate in his CAPM analysis (4.13%), Mr. McNally should have utilized the average Blue Chip forecasts of T-bond yields for the next six quarters (4.67%). (Staff Initial Brief at 28-32; IAWC Ex. 8.00R1 Rev. at 3; IAWC Ex. 8.00SR Rev. at 4) Likewise, Staff states, Ms. Ahern also avers that, rather than using the then-current 10- and 30-year T-bond yields to estimate the growth for the third stage of his NCDCF analysis (4.54%), Mr. McNally should have utilized Energy Information Administration ("EIA") forecasts of gross domestic product ("GDP") (4.92%) or Blue Chip forecasts of T-bond yields (5.70%).

Staff claims Ms. Ahern's argument for the substitution of forecasts for the then-current T-bond yields is untenable. There is no valid justification for disregarding the investor expectations imbedded in objective, observable current market data in favor of a proxy for those expectations imbedded in speculative projections, Staff argues. (Staff Initial Brief at 28-29)

Regarding Ms. Ahern's contention, based on long-term forecasts, that the risk free-rate and third-stage growth estimates Mr. McNally used in his NCDCF analysis are too low, Staff emphasizes that T-bond yields reflect market forces, while forecasts do not. Thus, Staff contends the forecasts Ms. Ahern advocates are merely proxies for investor expectations, and should be used only when the market variable in question is not observable. The true risk-free rate is reflected in the return investors are willing to accept in the market. As of September 2, 2009, investors were willing to accept a 4.13% return on T-bonds. (Staff Ex. 11.0 at 2-3)

Staff takes issue with Ms. Ahern's claims that Mr. McNally's use of the most-recent spot rate at the time of his analysis is inconsistent with the prospective nature of the cost of capital. In Staff's view, her argument is incorrect, since a U.S. Treasury yield <u>is</u> the cost of capital for that U.S. Treasury security. (Staff Initial Brief at 29-30)

Ms. Ahern testified that Mr. McNally's DCF analysis also uses an incorrectly calculated 20-year forward US Treasury yield of 5.37%. Ms. Ahern asserts that the correct yield, using Mr. McNally's work papers in part, is 5.70%. In response, Staff argues that Ms. Ahern's "corrected" 5.70% implied 20-year forward U.S. Treasury yield is incorrectly calculated. (Staff Initial Brief at 31-32, citing IAWC Ex. 8.00SR Rev. at 3-4)

3. IIWC's Position

IIWC recommends the Commission approve a return on common equity ("ROE") for the Company of 10.0%. (IIWC brief at 4) In arriving at this estimate, IIWC witness Mr. Gorman applied a constant growth discounted cash flow model; a sustainable growth DCF model, a multi-stage growth DCF model, and a capital asset pricing model to groups of publicly traded utilities which he determined reflected an investment risk similar to that of Illinois-American. (IIWC Ex. 1.0 at 15).

Specifically, Mr. Gorman identified three utility proxy groups with investment risks deemed similar to that of the Company. He used the water proxy group developed by Company witness Ms. Ahern, excluding one company, SJW Corp., because it did not have a credit rating from S&P or Moody's. Next, he separated the electric and gas utilities used by Ms. Ahern in her 26 utility proxy group into two separate groups, an electric group and a gas group. (IIWC Ex. 1.0 at 16)

Mr. Gorman noted that the water proxy group had an average corporate credit rating from S&P of "A" and that the corporate credit rating of IAWC's parent, American Water Works, was "BBB+." He considered these corporate credit ratings to be comparable. He also noted that IAWC is not currently rated by S&P, but receives all of its capital from its parent, American Water Works. Therefore, he concluded that the American Water Works credit rating is the relevant rating to consider in assessing the comparability of his proxy risk group.

He also noted that the average common equity ratio of his water proxy group was comparable to that of IAWC and that IAWC has an "Excellent" business risk profile, which was identical to the business risk profile of the water proxy group. (IIWC Ex. 1.0 at 17)

Mr. Gorman also considered the bond rating of his gas proxy group to be comparable to the bond rating of American Water Works and, therefore, the gas proxy group had comparable investment risk to that of IAWC. He noted the gas proxy group had an average common equity ratio that he considered to be comparable to the common equity ratio for IAWC. Additionally, he noted the gas proxy group had an "Excellent" business risk profile, the same as IAWC. (IIWC Ex. 1.0 at 17-18)

Finally, Mr. Gorman concluded that his electric proxy group was also similar in investment risk to IAWC based on comparable bond ratings for the proxy group and American Water Works, as well as comparable common equity ratios and the same "Excellent" business risk profile. (IIWC Ex. 1.0 at 18-19)

Based on the analysis discussed above, Mr. Gorman concluded that the proxy water group, the proxy gas group and the proxy electric group had comparable investment risk to IAWC. Mr. Gorman performed his various cost of equity analyses on his proxy groups. (IIWC Ex. 1.0 at 15)

Mr. Gorman testified that the premise of a DCF analysis is that the price of an individual stock is determined by the present value of all expected future cash flows discounted at the investors required rate of return. (IIWC Ex. 1.0 at 19). He used a constant growth version of the DCF model, which assumes that earnings and dividends will grow at a constant rate. The model requires a current stock price, expected dividend, and expected growth rate in dividends. (IIWC Ex. 1.0 at 19). Mr. Gorman used two different versions of the constant growth DCF model. The first relied on security analysts' growth rate estimates as the proxy for the expected growth rate in dividends, and the second assumed the sustainable growth rate based on the internal growth rate methodology including external financing, as the proxy for the expected growth rate.

His constant growth DCF analysis that relied on security analysts' growth rate estimates indicated average returns on equity of 10.61% for his water group, 13.23% for his electric group and 9.75% for his gas group. (IIWC Ex. 1.0 at 22) However, with regard to his comparable water group and his comparable electric group, this version of the constant growth DCF analysis produced unreliable results; whereas, his constant growth DCF model, using the consensus analysts growth rates estimates for the gas group, produced a reasonable result, in Mr. Gorman's opinion. (IIWC Initial Brief at 8) Among other things, Mr. Gorman asserted that the growth rates for his water group and electric group were not sustainable in that they exceeded the projected rate of growth of the overall U.S. economy, as well as the historical rate of inflation. (IIWC Ex. 1.0 at 26-27)

The second version of the constant growth DCF model used by Mr. Gorman was based on the same inputs as the first, except the growth rate was not based on financial analysts' projections. Instead, a sustainable growth rate was calculated. A sustainable growth rate estimates the amount of growth a utility can sustain indefinitely by retaining a percentage of its earnings, reinvesting those earnings in plant, and growing rate base and earnings for an indefinite period of time. (IIWC Initial Brief at 9-10; IIWC Ex. 1.0 at 29) This analysis produced an average return on common equity of 9.31% for his water group, 9.68% for his gas group and 10.31% for his electric group.

Mr. Gorman conducted a multi-stage growth DCF analysis to reflect the outlook of changing growth expectations. (IIWC Initial Brief at 9-10; IIWC Ex. 1.0 at 32) The multi-stage growth DCF reflects three growth periods: short-term (first 5 years); transition period (next 5 years); and long-term (11th year through perpetuity). For the short-term period, Mr. Gorman relied on the consensus analysts' growth projections used in his constant growth DCF (analyst growth) model. For the transition period, growth rate estimates were reduced or increased by an equal factor reflecting the difference between the analysts' growth rates and the GDP growth rate (growth rate in the U.S. economy). For the long-term period, he used the growth rate in the U.S. economy. (IIWC Ex. 1.0 at 33) He relied on the same 13-week stock price and quarterly dividends used in his constant growth DCF models.

His multi-stage growth DCF model produced an estimated common equity cost for his water proxy group of 9.11%, for his gas proxy group of 9.73%, and for his electric proxy group of 11.74%. (IIWC Ex. 1.0 at 35)

Based on the results of both constant growth DCF models and his multi-stage growth DCF model, Mr. Gorman concluded that the DCF returns on common equity for his proxy groups were: 9.12% water; 9.72% gas; and 11.03% electric. He developed a range of 9.7% to 10.2% and concluded that the Company's DCF cost of equity fell within that range at 10%. (IIWC Ex. 1.0 at 36)

Mr. Gorman also relied on a capital asset pricing model method to develop his recommended return on common equity for the Company. (IIWC brief at 11-12) The underlying theoretical basis for the CAPM method is that the market requires a return for a security equal to a risk-free rate of return plus a risk premium adjusted for a particular stock's risk relative to the overall market risk. (IIWC Ex. 1.0 at 41-42) The relationship between risk and return is expressed mathematically as: $R_i = R_f + B_i \times (R_m - R_f)$ where:

R_i equals required return for stock;
R_f equals risk-free rate;
B_i equals beta-measure of risk of stock;
R_m equals expected return on the market.

Because the risk-free rate is typically represented by U.S. Treasury securities, Mr. Gorman used Blue Chip Financial Forecasts' projected 30-year Treasury bond yields for his risk-free rate. (IIWC Ex. 1.0 at 43) The beta term in his CAPM analysis is the average beta estimate for his comparable groups of companies. He then determined a return on the overall market in order to develop his risk premium estimate for the CAPM analysis. He developed two market risk premium estimates for his analysis. The first was based on forward-looking projections, and the second was based on a long-term historical market return. He developed his forward-looking risk premium estimate by estimating the expected return on the market (represented by the S&P 500) and subtracting the risk-free rate from the estimate. The long-term historical returns were provided by Morningstar's Stocks, Bonds, Bills, and Inflation 2009 Yearbook. (IIWC Ex. 1.0 at 44-45)

He also developed a third market risk premium estimate. This estimate was an expectational market risk premium estimate using a DCF return on the market. Mr. Gorman made this estimate in response to the Commission's previously expressed concerns regarding his use of only historic information for his CAPM analysis. (IIWC Ex. 1.0 at 46, 47-49)

Mr. Gorman's CAPM analysis for each of his proxy groups produced an average return on equity estimate of 9.22% for his water group, 8.80% for his gas group, and 9.00% for his electric group. (IIWC Ex. 1.0 at 49-50)

Based on the analyses discussed above, Mr. Gorman concluded the Company's cost of equity is 10.0%. (IIWC Initial Brief at 12-13; IIWC Ex. 1.0 at 50-51) Because Mr. Gorman's recommended return on common equity is based on the cost of equity for companies with risks similar to that of the Company, it is commensurate with returns investors could earn by investing in other enterprises of comparable risk and will allow capital to be attracted to the Company under reasonable terms, in IIWC's view.

IIWC witness Gorman testified that Ms. Ahern's DCF return estimates were overstated because they relied on growth rates in the constant growth rate DCF model that exceed reasonable estimates of long-term sustainable growth. (IIWC Initial Brief at 13-14) According to Mr. Gorman, Ms. Ahern's capital asset pricing model also produces an excessive return on common equity because the market risk premium she uses, which is based on a DCF return on the market of 14.75%, is significantly overstated. (IIWC Ex. 1.0 at 58-59)

IIWC also takes issue with the business and financial risk "adders" proposed by IAWC. (IIWC Initial Brief at 16-20) The business risk adder is based largely on the size of IAWC compared to the size of the companies included in her proxy groups, and size-based adders have been previously rejected by the Commission for IAWC, in Docket No. 07-0507, and other companies. In addition, IIWC asserts, if the proxy groups used to develop the return on equity are reasonably comparable to IAWC, such proxy group would already reflect all relevant risk factors, including those related to size. (IIWC Initial Brief at 18; IIWC Ex. 1.0 at 63-64)

Regarding the financial risk adjustment, IIWC states, Ms. Ahern's comparable companies have similar business and financial risks and, to the extent they are comparable to IAWC, have business and financial risks which are similar to those of IAWC. Thus, there is no need to adjust upward a return on equity calculated using those comparable companies to reflect the alleged financial risk, in IIWC's view. (IIWC Initial Brief at 19)

In addition, Mr. Gorman testified, IAWC's parent company has a credit rating of "BBB+" from S&P and "Baa2" from Moody's, which is higher than the bond rating Ms. Ahern has assumed for IAWC in her analysis and comparable to the credit rating of her proxy group of companies. If IAWC were rated, its credit could have been comparable to the credit rating of the comparable companies, in Mr. Gorman's opinion. (IIWC Initial Brief at 20)

4. CUB's Position

CUB witness Mr. Thomas recommends the Commission adopt a 7.44% cost of equity capital based solely on the averaged results of his CAPM (8.03%) and DCF (6.85%) analyses. (CUB Initial Brief at 4; CUB Ex. 1.0 at 39)

There are two fundamental differences between Mr. Thomas' DCF model and that used by IAWC. First, CUB asserts, Mr. Thomas uses a more representative sample of companies to gauge the level of risk investors would associate with IAWC. Second, Mr. Thomas uses a multi-stage growth rate analysis to predict how companies compared to IAWC will grow over the next five years. (CUB Initial Brief at 7)

Regarding the sample, Mr. Thomas used the same sample of six water companies as used by Ms. Ahern. (CUB Ex. 5.0 at 11) However, in Mr. Thomas' opinion, the size and business functions of the 26-firm publicly traded utilities is not comparable to IAWC and thus not an appropriate basis for comparison when determining the cost of equity capital for IAWC.

Regarding growth rates in the DCF analysis, Mr. Thomas complains that the analysts' forecasts that Ms. Ahern relied upon are significantly greater than historic internal growth actually experienced by the companies in the water sample. (CUB Initial Brief at 9) The historic internal growth method used by Mr. Thomas is a simple recognition that past growth is the best proxy for future growth, in Mr. Thomas' view. (CUB Initial Brief at 10; CUB Ex. 2.0 at 5)

In the CAPM analyses, the problem with the beta coefficient used by Ms. Ahern, in Mr. Thomas' view, is that she uses raw beta estimates, adjusted for mean reversion, as valid CAPM inputs (the Value Line estimates). (CUB Initial Brief at 13) However, Mr. Thomas asserts, the risk (beta) of utility companies has not been shown to move towards the risk (beta) of other non-utility companies. Similarly, utility betas have not been shown to trend to a beta of 1.0. Thus, CUB argues, the unwarranted adjustment improperly increases betas and the overall CAPM cost of equity. (CUB Initial Brief at 14, citing CUB Ex. 1.0 at 29)

CUB next addresses the "ERMP." (CUB brief at 15) In the CAPM model, the expected market risk premium ("EMRP") represents the premium, above the risk-free rate, that investors expect when they take on the risk of an investment in the market portfolio, or the universe of potential investment opportunities available to investors. (CUB Ex. 1.0 at 32) Ms. Ahern used analysts' forecasts to compute an EMRP of 10.32%. In Mr. Thomas' opinion, the use of analysts' growth forecasts in determining investors' growth expectations is an unreliable method, and as a result, Ms. Ahern's EMRP is grossly overstated.

There are two main approaches to deriving the EMRP input for a CAPM analysis: either EMRP estimates derived from the academic studies of market performance are used, or an EMRP estimate is calculated for particular situations or cases. Ms. Ahern uses the latter approach.

CUB claims that questions concerning the appropriate EMRP have been called "the most debated issue in finance" and "the premier question relating to the cost of capital, for theorists and practitioners alike." Given the uncertainty, CUB suggests the Commission should look to research and analysis performed by unbiased academics over many years instead of the assertions or ad hoc calculations of interested participants in economic contests.

The overwhelming conclusion from current research on the EMRP, Mr. Thomas states, is that the return expected by investors and appropriate for use in the CAPM is far lower than returns calculated from selective samples of historic information. (CUB Ex. 1.0 at 34) According to CUB, the historic record, financial theory, and prospective estimates based on stock prices and growth expectations, all indicate that the future equity premium in developed capital markets is likely to be between 3 and 5%. This actual risk premium is far lower than the 8% historic returns calculated from selective historic data would indicate.

CUB asserts that instead of relying on theoretical modeling and quibbling over data, there is data available from actual surveys of investors. (CUB Ex. 1.0 at 35)

This research justifies an EMRP in the range of 3.0 to 5.0%, with some research indicating that the actual EMRP is much lower. (Id.) Recognizing that the Commission has typically adopted an EMRP estimate that is calculated for a specific case, Mr. Thomas used the higher end of the EMRP spectrum in his CAPM analysis, 5%. Ms. Ahern's 10.32% estimate, which is outside the estimates provided by the academic research, is at the high-end of the spectrum. (CUB Ex. 1.0 at 38) Calculating an individual EMRP based upon analysts' forecasts inappropriately reflects the current short-term discontinuity where the Commission's task is to set a cost of equity capital that is sustainable over the period that rates are in effect, in CUB's view. (CUB Ex. 2.0 at 8)

In terms of CAPM results, the CAPM produces results that range from 6.72% to 9.34% (average 8.03%) even when Ms. Ahern's "grossly inflated" EMRP estimate is used as an input. (CUB Initial Brief at 17)

In CUB's view, the Commission should adopt a 7.44% cost of equity capital based on the averaged results of Mr. Thomas' CAPM (8.03%) and DCF (6.85%) analyses. (CUB Initial Brief at 17)

CUB also takes issue with IAWC's proposed business risk adjustment. CUB argues that IAWC's proposal is a repackaged version of adjustments the Commission has denied in the past. (CUB Initial Brief at 19-21)

Regarding the financial risk adjustment, CUB contends that this adjustment is unwarranted since there is no evidence of what IAWC's debt would be rated at, were it actually to be rated by Moody's and S&P. CUB cites allegations that credit ratings are artificially inflated. (CUB Initial Brief at 17-18)

5. The AG's Position

For the cost of common equity, AG/JM witness Mr. Ralph Smith, in rebuttal testimony, recommended 10.19 percent, which is an average of the 10.38 percent recommended by Staff witness McNally and the 10.00 percent recommended by IIWC witness Gorman. (AG/JM Ex. 5.0 at 16) In its initial brief, the AG instead argues that the Commission should approve the return on equity proposed by CUB witness Mr. Thomas. (AG Initial Brief at 47-48)

6. IAWC's Reply to Other Parties

IAWC contends that the DCF and CAPM analyses offered by Mr. Gorman, and relied upon by IIWC, contains several flaws for which “corrections” were offered by IAWC. (IAWC Initial Brief at 92-96; Reply Brief at 67) IIWC’s DCF analysis is faulty, IAWC asserts, because (1) Mr. Gorman improperly excluded data produced by his constant-growth model, (2) Mr. Gorman’s use of a sustainable growth model was both illogical and previously rejected by the Commission, and (3) Mr. Gorman’s multi-stage DCF model incorrectly excluded relevant data.

In IAWC’s view, Mr. Gorman’s CAPM analysis was similarly flawed because his (1) derivation of the historical market equity risk premium is incorrect, (2) “forward-looking” equity risk premium is not truly a prospective equity risk premium, and (3) use of an internal market growth rate estimate and a non-constant growth DCF in determining a market equity risk premium is inconsistent with the methodology adopted by the Commission in IAWC’s last rate case, Docket No. 07-0507, and Staff’s analysis in the current proceeding. In testimony and in IAWC’s Initial Brief, the Company proposed adjustments to correct these errors, which IAWC claims were not refuted by IIWC. Consequently the Commission should accept Ms. Ahern’s adjustments, IAWC argues.

IAWC witness Ms. Ahern proposed to "correct" Mr. McNally’s DCF and CAPM analyses. Staff witness Mr. McNally’s multi-stage DCF analysis, which he offers as an alternative to Ms. Ahern’s calculations, contains two flaws, in Ms. Ahern’s opinion, which understate the cost of common equity. His use of recent spot yields of US Treasury securities is inconsistent with the prospective nature of both the cost of capital and ratemaking as well as the Efficient Market Hypothesis (“EMH”), particularly when forecasts of U.S. Treasury security yields are readily available. (IAWC Ex. 8.00R1 Rev. at 2-3) Mr. McNally fails to account for the fact that forecasts of the yields on U.S. Treasury securities are readily available based upon a consensus of approximately 50 of the country’s leading economists from Blue Chip Financial Forecasts, and as soon as those forecasts are publicly available, under the EMH, they are immediately assimilated by investors. (IAWC Ex. 8.00SR Rev. at 2) Mr. McNally also does not utilize readily available GDP growth forecasts, instead relying upon an “implied” growth rate. Mr. McNally’s use of improper data results in lower-than-expected DCF estimates. (IAWC Ex. 8.00R1 Rev. at 3-4)

Mr. McNally’s DCF analysis also uses an incorrectly calculated 20-year forward US Treasury yield of 5.37%, IAWC argues. Ms. Ahern argued that the correct yield, using Mr. McNally’s work papers in part, is 5.70%. This makes the corrected DCF result for his Utility Group, upon which he relied exclusively in formulating his recommended 10.38% common equity cost rate for IAWC, 11.55%.

Regarding Staff’s CAPM analysis presented, IAWC asserts that Staff witness McNally’s CAPM analysis relies on an improper risk-free rate. (IAWC Initial Brief at 93) Mr. McNally uses a historical spot 30-year U.S. Treasury bond yield as the risk-free rate, rather than an actual projection of the 30-year U.S. Treasury bond yield. Use of a spot rate, IAWC argues, is inconsistent with both the prospective nature of the cost of capital and ratemaking as well as the EMH. (IAWC Ex. 8.00R1 Rev) From the September 1, 2009 Blue Chip Financial Forecasts, a forecasted 30-year U.S. Treasury Bond (note) yield of 4.67% can be derived, based upon the consensus forecast of about 50 economists of the expected yield on 30-year U.S. Treasury Bonds (notes) for the six calendar quarters ending with the fourth calendar quarter of 2010. Utilizing Mr. McNally's average betas for his Water Group and Utility Group of 0.68 and 0.69, respectively, as well as the forecasted 4.67% 30-year U.S. Treasury Bond (note) yield as the risk-free rate, the CAPM cost rates under his model calculate to 10.19% and 10.21% respectively.

The 10.99% and 11.55% corrected DCF results, when coupled with the corrected CAPM analysis of Mr. McNally for his Utility Group of 10.21%, result in a range of common equity cost rate of 10.60% to 10.88%, before any adjustment for IAWC's greater relative financial and business risks. (IAWC Initial Brief at 94)

According to IAWC, Staff's response to Ms. Ahern's use of forecasts to replace Mr. McNally's use of spot yields mischaracterizes the nature of such forecasts and should be disregarded. Staff incorrectly characterizes forecast data as only proxies for investor expectations. However, as explained by Ms. Ahern in her surrebuttal testimony, her analysis represents a consensus of approximately 50 of the country's leading economists from Blue Chip Financial Forecasts.

Staff also asserts that there is "no valid justification" not to use the spot yield figures. (Staff Initial Brief at 28) IAWC disagrees. The forecasts represent information readily available to investors that impacts their behavior. Further, use of such data is more appropriately in keeping with the prospective nature of ratemaking. (IAWC Ex. 8.00SR at 3) Last, contrary to Mr. McNally's view, such forecasts are no less appropriate than are the Zacks' long-term forecasts of earnings per share growth utilized by Mr. McNally in his DCF analyses.

Finally, Staff's critique of Ms. Ahern's recalculation of Mr. McNally's implied 20-year forward U.S. Treasury yield, from 5.37% to 5.70%, must be rejected, in IAWC's view. (Staff Initial Brief at 31-32) Staff fails to cite a single exhibit in support of its analysis. Consequently, this argument, having no basis in the record, should be disregarded by the Commission, IAWC argues. (IAWC Reply Brief at 68-69)

In response to CUB, IAWC says CUB mischaracterizes Ms. Ahern's proposal to make a business risk adjustment by claiming it is a previous rejected market-to-book ratio adjustment. Ms. Ahern's business risk adjustment in no way advocates a market-to-book ratio adjustment, and is instead meant to account for IAWC's small size relative to the proxy companies, regulatory risks specific to Illinois, the availability and quality of IAWC's water supply, and IAWC's concentration of sales-for-resale customers. (IAWC Reply Brief at 69)

In response to IIWC, IAWC argues that IIWC mischaracterizes the proposed adjustment as a previously rejected size-based adjustment, while ignoring the other factors relied upon by Ms. Ahern in calculating the adjustment. (IAWC Initial Brief at 87-89; Reply Brief at 70) Second, IAWC asserts, IIWC incorrectly assumes that because the companies in the proxy groups used to develop the ROE analyses have similar bond ratings, IAWC must have equal bond ratings. Finally, IIWC's assertion that the Company's status as a wholly-owned subsidiary should eliminate the need for a business risk adjustment is unsupported.

In response to Staff, The Company first takes issue with Mr. McNally's characterization of Ms. Ahern's estimation of market capitalization as purely hypothetical. Ms. Ahern estimated IAWC's market capitalization based upon the market-to-book ratios of the proxy group companies, which is no more hypothetical than using the market data of that very same proxy group to arrive at a cost rate of common equity applicable to IAWC because IAWC's is not directly observable. In other words, if the market data of a proxy group or groups is appropriate for cost of capital purposes for IAWC, that market data is also appropriate to use to estimate a market capitalization for IAWC. (IAWC Reply Brief at 70-71; IAWC Ex. 8.00SR Rev. at 7-8)

Second, IAWC claims Staff mischaracterizes the proposed business risk adjustment as a size-based adjustment; whereas, Ms. Ahern relied on a number of factors in calculating her proposed adjustment, which happened to include, but were not limited to, the relative size of IAWC. (IAWC Initial Brief at 87-89)

Third, the Company would correct the assertion of Staff that Ms. Ahern based her business risk adjustment solely on size and the Ibbotson study. This contention is directly contradicted by the testimony offered by Ms. Ahern in her surrebuttal, IAWC contends, where she identified a number of factors that went into her analysis of IAWC's relative business risk. (IAWC Ex. 8.00R2 Rev. at 16-17)

In response to IIWC's arguments regarding a proposed financial risk adjustment, the Company claims IIWC makes two contentions in its Initial Brief, both of which should be rejected. First, IIWC suggests that assuming the proxies used in credit rating analysis are valid proxies, and "assuming they have similar bond ratings," no adjustment is necessary. (IIWC Initial Brief at 20) IAWC claims that IIWC repeats the same analytical error here that it committed in arguing its position on business risk. Namely, rather than address the issue, IIWC has chosen to assume it away by supposing that proxies similar to IAWC in some respects, must therefore be similar in all respects, including bond rating. According to IAWC, it is because the proxies do not have the same financial risk as IAWC that an adjustment is necessary. (IAWC Initial Brief at 103-104; Reply Brief at 72)

Second, Ms. Ahern conducted an analysis of IAWC and determined that the Company's debt would be rated in the bottom of the BBB/Baa or top of the BB/Ba bond rating categories. (IAWC Initial Brief at 90) Because IIWC's has offered no evidence to refute Ms. Ahern's analysis, IAWC argues, IIWC's "unfounded criticisms" should be disregarded. (IAWC Reply Brief at 72)

In response to CUB, IAWC asserts, contrary to CUB's assertions, that Ms. Ahern did offer evidence of what IAWC's debt would be rated at were it to be rated by Moody's and S&P, and did not agree that credit ratings are artificially inflated. (IAWC Reply Brief at 72-73)

In response to Staff, IAWC argues that contrary to Staff's assertion, Ms. Ahern has not overstated the credit rating of the companies in Mr. McNally's utility group. In her testimony (IAWC Ex. 8.00SR Rev at 5), Ms. Ahern states "the Utility Group's credit rating is BBB," the same credit rating identified by Staff in the sentence immediately following the accusation that Ms. Ahern has overstated the Utility Group's credit rating. What Ms. Ahern did do, however, is base her financial risk estimate on the utility group's bond rating. As she explained, and despite Staff assertions to the contrary, because bond yields are based upon bond ratings and not credit ratings, it is imperative that any financial risk adjustment based upon those yields be based upon bond rating differences between IAWC's likely bond rating and the bond rating of the Utility Group. (IAWC Reply Brief at 73-74; IAWC Ex. 8.00SR Rev. at 5)

Second, Staff argues that Ms. Ahern has underestimated the credit rating for IAWC by "assum[ing]" a "Strong" business risk profile for IAWC. This assertion ignores the testimony offered by Ms. Ahern. Contrary to Staff's assertion, Ms. Ahern did support her conclusions. Ms. Ahern's analysis was based on her review of financial metrics for IAWC updated for 2008 on Schedule 8.05R2 and S&P's expanded business risk and financial risk matrix. (IAWC Ex. 8.00SR Rev. at 5) Ms. Ahern further buttressed her conclusion based on her analysis of the credit and bond ratings of IAWC's parent company.

Finally, Staff's own suggestion that IAWC should be rated differently is no less based on the "opinion" of Mr. McNally than IAWC's estimates were based on the "opinion" of Ms. Ahern. As demonstrated above, Ms. Ahern supported her conclusions with analysis of available data and showed that they were reasonable. (IAWC Reply Brief at 74)

Regarding the use of a sustainable-growth DCF model, IAWC asserts that Mr. Thomas' sustainable-growth DCF analysis was rejected by the Commission in Docket No. 07-0507. (IAWC Initial Brief at 98) In addition, Mr. Thomas states that he performed a multi-stage growth analysis that assumes that for the short-term, the companies in the sample will grow at their average internal growth rate over the last five years. Hence, Mr. Thomas relied solely upon historical retention growth. However, IAWC argues, since the cost of capital, as well as ratemaking itself, is prospective, his reliance upon historical, sustainable, fundamental growth is inconsistent with the prospective nature of both ratemaking and the cost of capital. According to IAWC, by ignoring projections of earnings per share, dividends per share and common equity such as those provided by Value Line Investment Survey and expected 3-5 years hence, Mr. Thomas has ignored a valuable investor-influencing and widely available source of forecasted information and the very source he utilized in his discussion about declining dividend payout ratios. (IAWC Initial Brief at 98)

In IAWC's view, Mr. Thomas's other position – that analysts' forecasts cannot be relied upon in the DCF calculation because of a "discontinuity" in the equity markets – ignores the empirical and academic literature which supports the superiority of such data in a DCF analysis. Further, growth rates are significantly influenced by this discontinuity. Security analysts are fully aware of the effect this discontinuity has on the credit and equity markets in general, and on specific companies and industries in particular, reflecting this knowledge when they make their forecasts. Thus, IAWC asserts, there is no need for the Commission to reconsider the use of analyst's forecasts of growth in earnings per share in the DCF calculation. (IAWC Ex. 8.00R2 Rev. at 8-9.)

Mr. Thomas's use of a three-stage DCF model with short-term growth, i.e., internal growth, persisting for five years, followed by a five-year period of transition and a third stage where growth is equivalent to the long-term historic growth in real GDP is unsound, IAWC argues. There is no evidence from historical nominal GDP growth rate data that the growth in each individual component of GDP going forward can be expected to converge toward GDP growth as a whole. Thus, IAWC argues, even nominal GDP growth is not an appropriate proxy for the long-term growth of utilities. Second, the use of growth in real GDP, i.e., without inflation, results in a mismatch with both the market prices utilized to develop the dividend yield in the DCF and the internal growth rate Mr. Thomas developed for use in the first and second or transitional stage of his three-stage DCF, because both market prices and the return on common equity utilized in the calculation of internal growth have inflation expectations embedded in them. Thus, IAWC contends, Mr. Thomas' use of real GDP growth results in an inconsistency in his application of the three-stage DCF. (IAWC Ex. 8.00R2 Rev. at 11)

Mr. Thomas objects to the use of adjusted betas in CAPM analysis. In Ms. Ahern's opinion, while companies can reduce their exposure to risk, they cannot reduce their exposure to systematic risk as measured by beta. Beta, as a measure of systematic risk, is largely out of the control of management. Systematic, or market, risk arises predominantly from macroeconomic factors which affect all companies. Non-systematic risks are those risks predominantly associated with a company's operations and financial profile. The market price fluctuations which give rise to beta are largely out of the hands of management and are in the hands of investors who price common stocks based upon their perceptions of the riskiness of investing in them based upon macroeconomic events which affect all stocks. Thus, systematic, or market, risk represents a non-diversifiable risk to shareholders except as may affect the financing decisions of companies relative to the issuance of additional shares of common stock. (IAWC Ex. 8.0R2 Rev. at 12-13)

The Commission has traditionally relied upon adjusted betas in arriving at a common equity cost rate for utilities under its jurisdiction. In IAWC's prior rate case, Docket No. 07-0507 (Order at 88), the Commission found, in response to Mr. Thomas's argument that adjusted betas be rejected, that it "has reviewed the testimony and arguments offered by CUB in favor of using unadjusted betas and does not find them convincing. Many of these arguments have been presented in previous proceedings where they were rejected." The Commission concluded in Docket No. 07-0507 that "adjusted betas are superior to unadjusted betas." (Id. at 14)

Mr. Thomas also takes issue with Ms. Ahern's derivation of equity market risk premium in the CAPM analysis, presenting arguments that the Commission has reviewed and discarded in a prior proceeding. By rejecting Ms. Ahern's derivation of the EMRP, IAWC argues, Mr. Thomas effectively rejects the Commission's derivation of the EMRP, since the Commission relied upon the CAPM analyses of both Ms. Ahern and Staff in IAWC's last rate case, Docket No. 07-0507. Mr. Thomas relies instead on what he calls "research and analysis performed by unbiased academics over many years." However, such reliance is inconsistent with the discontinuity, turmoil and uncertainty in capital markets due to the recent financial crisis and recession, because each of the studies upon which he relies was published between 2004 and 2005, well before the start of the current recession in late 2007 and the market free fall which began in September 2008. The Commission rejected this argument in Docket No. 07-0507, IAWC states. (IAWC Initial Brief at 100)

IAWC states that the AG has made no arguments of its own in its Initial Brief regarding the cost of common equity. (IAWC Reply Brief at 76) Instead, it incorporates the proposal of Mr. Thomas by reference. (AG Initial Brief at 11) In so doing, IAWC argues, the AG has ignored the testimony of its own witness, Mr. Smith, who testified that the cost of common equity should be 10.19%, which is an average of the estimates of Mr. McNally and Mr. Gorman. (AG/JM Ex. 5.0 at 16) However, the above-noted IAWC-proposed business and financial adjustments to those analyses would also be applicable to Mr. Smith's recommended average, IAWC asserts.

7. Commission Conclusion

Through their respective witnesses, IAWC, Staff, IIWC, CUB, and the AG/Joint Municipalities presented recommendations on IAWC's cost of common equity. IAWC, Staff, IIWC, and CUB witnesses estimated IAWC's cost of equity using both discounted cash flow ("DCF") and capital asset pricing model ("CAPM") analyses. These analyses were applied to sample groups deemed comparable to IAWC, since IAWC's stock is not publicly traded.

IAWC's initial recommendation was 12.25%. After reviewing the testimony of Staff and Intervenor witnesses, however, Ms. Ahern testified in support of a range of common equity cost rates of 10.70% to 11.10%, and IAWC has selected the midpoint of this range, 10.90%, as an appropriate common equity cost rate for this proceeding. The IAWC recommendation contains upward adjustments, also referred to as "adders" for business and financial risk, which are opposed by all other parties who commented on this issue.

The Staff witness recommended a cost rate of 10.38%, which is the midpoint of his DCF estimate of 10.72% and CAPM estimate of 10.04% for the sample group viewed as most comparable to IAWC.

After performing DCF and CAPM analyses, the IIWC witness testified that the Company's cost of equity is 10.0%.

The CUB witness recommends that the Commission adopt a 7.44% cost of equity capital based on the averaged results of his CAPM, 8.03%, and DCF, 6.85%, analyses.

The AG witness testified that the cost of equity should be the average of the Staff and IIWC proposals, which is 10.19%. In its Initial Brief, the AG instead argues that the Commission should approve the return on equity proposed by CUB witness Mr. Thomas.

Having reviewed the positions of the parties, and putting aside the question of adjustments for business and financial risk, discussed below, the Commission observes that the Staff and IIWC recommendations are somewhat similar and both appear to be generally sound. Of the two, the Staff proposal seems better suited for use in this proceeding, in part due to the Staff witness' explanation of his reasons for not accepting the IAWC "corrections" to the Staff DCF and CAPM analyses.

One such example is Staff's reasons for using then-current 30-year Treasury-bond yields rather than the average analysts' Blue Chip forecasts of Treasury-bond yields. The Staff witness testified that the most-recent spot rate at the time of his analysis is not inconsistent with the prospective nature of the cost of capital, since a U.S. Treasury yield is the cost of capital for that U.S. Treasury security. While experts may disagree over which data is most appropriate for use in these complicated analyses, as they have here, the Commission does not believe the record in this case requires that corrections be made to the Staff's DCF and CAPM determinations.

Based on the evidence, the Commission believes that Staff's analyses are supported in the record, produce reasonable results and should be utilized.

CUB witness Mr. Thomas' proposal, based on his DCF and CAPM analyses, will not be adopted. Compared to all the other DCF and CAPM analyses presented, his are overly dependent on historic data, particularly in the calculation of growth rates in the DCF study and market risk premium in the CAPM analysis. Also, inclusion of an accurately calculated beta adjustment in the CAPM properly reflects the effect of systematic or market risk on a forward-looking basis, and proposals to rely on unadjusted betas have been previously rejected by the Commission. As a consequence, the results of Mr. Thomas' analyses are less reliable than those presented by other parties for purposes of this proceeding.

As discussed above, IAWC's proposal includes adjustments or adders of 15 (0.15%) and 30 (0.30%) basis points to reflect business and financial risk. These adjustments are opposed by Staff, IIWC and CUB witnesses. Based on the record, the Commission finds that these adjustments should not be made. As the other parties have asserted, the Company witness has not demonstrated that IAWC's business or financial risk is higher than that in the groups of comparable companies in the samples.

In that regard, Staff and Intervenor witnesses have testified that a business risk premium based on the relative market value size of utilities has not been shown to be consistent with financial theory. Those parties also indicate that somewhat similar adjustments have been rejected by the Commission.

The IAWC witness' financial risk adjustment is based on a comparison of the actual credit ratings for Mr. McNally's sample, which are derived from S&P's assessments of financial risk profile, to her estimate of IAWC's credit rating derived from her assessment of the financial risk profile that focuses on three financial ratios. Mr. McNally's analysis of this comparison, summarized above, supports his conclusion that the purported difference in credit ratings has not been demonstrated. As a result, the Commission concludes that IAWC's proposals to make upward adjustments to the results estimated for the comparable samples are not warranted.

In conclusion, the Commission finds that IAWC's cost of common equity is in the range of 10.04% to 10.72%, and that a mid-point cost rate of 10.38% would be appropriate for purposes of calculating IAWC's cost of capital and setting rates in this proceeding.

D. Approved Cost of Capital and Rate of Return on Rate Base

Taking into consideration the Commission's conclusions regarding capital structure, cost of short-term debt, cost of long-term debt, and cost of common equity the Commission finds that IAWC should be authorized to earn a rate of return of 8.05 % on its rate base. The table below shows the development of that authorized rate of return:

Component	Percentage	Cost	Weighted Cost
Short-term debt	2.83%	1.00%	0.03%
Long-term debt	49.84%	6.24%	3.11%
Common equity	47.33%	10.38%	4.91%
Total	100%		**8.05%**

VII. COST OF SERVICE

IAWC performed a cost of service study using the Base-Extra Capacity method to functionalize, classify and allocate costs to each of its customer classes. As discussed later in this order under "Rate Design," rates within each class are designed to generate an appropriate level of revenues for that class, generally through (1) fixed monthly customer charges based on meter size, and (2) unit rates based on usage or consumption.

In Docket No. 07-0507, the Commission discussed at length general considerations regarding movement toward single tariff pricing ("STP"), as well as a number of specific rate design issues, such as inclining block structures, the movement of fixed charges into the customer charge, and implementation of demand charges for nonresidential customers. In the current docket, IAWC is proposing several steps towards STP, including moving Sterling and Champaign into rate Zone 1 (which encompasses IAWC's Southern, Pontiac, Streator, Peoria and South Beloit districts), and implementing uniform customer charges, block structures and usage charges in Zone 1 (with the exception of the 5/8" meter customer charge) as discussed in the Rate Design section below.

As noted above, IAWC performed a cost of service study using the Base-Extra Capacity method to functionalize, classify and allocate costs to each of its customer classes.

With regard to cost of service, the first issue addressed by IAWC and Staff, and in this order, concerns the demand factors that should be used in a cost of service study to establish IAWC's rates.

Other evidence and issues relating to cost of service, including the Company's cost of service study, are addressed after that.

Rate design is addressed in the next section, Section VIII, of this order.

A. Demand Factors

In the past, the Commission has expressed concerns regarding the demand factors that should be used in a cost of service study to establish IAWC's rates. These concerns were expressed in Docket No. 07-0507 and in the Commission's initiating order in Docket No. 08-0463. As discussed below, there is disagreement over the usefulness of the demand factors presented by IAWC in this proceeding.

1. IAWC's Position

IAWC submitted a demand study, entitled "Report on Capacity Factors by Customer Class for the Illinois-American Water Company" ("Capacity Factors Report"), which it says provides updated demand factors for all IAWC's Rate Areas. (IAWC Ex. 13.01R1) IAWC states that the Capacity Factors Report used data from each Rate Area to determine demand factors for that Rate Area. IAWC indicates that it utilized actual demand data that was available for certain Chicago Metro service areas and data obtained in the Docket No. 07-0507 demand study to confirm the reasonableness of the results of the Capacity Factors Report where appropriate. IAWC claims the Capacity Factors Report is substantially similar to the prior report prepared in Docket No. 08-

0463, and the demand factors provided in the Capacity Factors Report as initially submitted were unchanged from those submitted in the prior report. These demand factors were utilized in the preparation of a cost of service study ("COSS") by IAWC's witness Mr. Herbert, which is provided as IAWC Exhibit 9.01. (IAWC Initial Brief at 105-106)

In IAWC's view, it is significant that on October 15, 2008, in Docket No. 08-0463, the Commission granted the Joint Motion for Clarification and expressly approved the use of the IAWC's proposed methodology for the demand study. (IAWC Initial Brief at 105) IAWC says the approved methodology for the Capacity Factors Report expressly stated that actual demand data would be used "to the extent possible" to develop various adjustment factors. (IAWC Initial Brief at 107, Reply Brief at 76-77)

In its Reply Brief, IAWC says it does not maintain that, in Docket No. 08-0463, the Commission approved all aspects of the Capacity Factors Report, or that the approved methodology identified all the data to be used in the Capacity Factors Report and the details of the application of that data. For example, IAWC does not maintain that the specific approach used in the Capacity Factors Report to develop the residential daily variation factors ("RDV") was approved by the Commission. Rather, IAWC maintains that the Capacity Factors Report was developed in accordance with, and consistent with, the approved methodology, which set forth the steps to be taken in performing the study. In IAWC's view, Staff's assertion that the Commission's approval of the methodology left to a later date the development of a specific plan is misguided.

IAWC does not disagree that the detailed implementation of the Commission-approved methodology was performed later, as explained in the Capacity Factors Report. IAWC insists that the Capacity Factors Report was prepared in accordance with the approved methodology and the data used was consistent with the approved methodology. IAWC believes Staff's conclusion, that there is no basis to conclude that the Commission has given prior approval in any form IAWC's proposals in this case, is incorrect. IAWC says the Commission approved the indirect study methodology as IAWC proposed, and IAWC maintains that the Capacity Factors Report is consistent with that methodology. (IAWC Reply Brief at 77-78)

IAWC contends that the Capacity Factors Report produced reasonable results. According to IAWC, the Capacity Factors Report's results are typical of the range of capacity factors in other water utilities, and, when compared to system coincidental demands, produce diversity ratios generally in the range considered reasonable by the American Water Works Association Manual M1 ("AWWA Manual"). IAWC states that while the diversity factors produced in the report were generally within the AWWA Manual's range of reasonableness, the Chicago Metro rate group's diversity factor was outside the AWWA Manual's range. IAWC asserts that given the primarily residential nature of the customer base in Chicago Metro, the diversity ratio for that area is reasonable as well. (IAWC Initial Brief at 106-107)

According to IAWC, the Demand Study developed capacity factors based on system and customer billing data gathered from each IAWC district, so that capacity factors for each district were based on data from that district. IAWC states that, consistent with the approved methodology, actual data was used where appropriate in developing the demand factors. IAWC states that its four Chicago Metro service areas were almost entirely residential, so the actual measured demand data from these areas could be used to confirm the reasonableness of daily demand variation estimates that were used to develop the final demand factors in the Capacity Factors Report. (IAWC Initial Brief at 107)

IAWC indicates that the residential daily variation ("RDV") factors or ratios which were utilized in determining the final capacity factors were first developed as estimates based on a number of considerations, including judgment supported by the reasonableness of the resulting system diversity factors, the relationship of prior and measured residential capacity factors to other customer classes, how resulting capacity factors compared with capacity factors previously used to design IAWC water rates in prior rate cases, and how resulting capacity factors compared with customer class capacity factors determined in other water rate studies. IAWC adds that one factor considered in determining the RDV factor was actual daily pumpage records of 2,161 residential accounts within four Chicago Metro service areas that serve residential customers either exclusively or with very little influence from other customer classes. IAWC claims this type of residential data is not generally available for other districts operated by the Company. IAWC considered the ability to utilize such actual residential data relevant and significant, because a goal of the demand study methodology was to use actual data where reasonably possible. (IAWC Initial Brief at 107-108, Reply Brief at 79)

IAWC says five districts within the Chicago Metro rate area were identified as isolated systems that were primarily residential and had a master meter for the area that was connected to the SCADA system, and so were selected for analysis. IAWC adds that one of the districts (Terra Cotta) was removed from consideration when it was discovered that several days of water usage was being met by a new water tank before being refilled, resulting in several days with no indicated pumpage data. Of the four remaining districts, IAWC indicates that the percentage of July 2005 water usage attributed to residential customers was as follows: Liberty Ridge – 99.1 percent; Arrowhead – 99.6 percent; Liberty Ridge East – 100 percent; and Alpine Heights – 100 percent. IAWC says these four districts served 2,161 residential customers in 2005. (IAWC Initial Brief at 108)

According to IAWC, maximum day and average day pumpage for these areas was used to determine a ratio of maximum day pumpage to average day pumpage in the maximum month (the "Residential MD/ADMM"). To determine the RDV factor for each rate area, IAWC indicates that the Residential MD/ADMM was divided by the ratio of system maximum day to average daily pumpage in the year's maximum month (the "System MD/ADMM"). (IAWC Initial Brief at 108)

IAWC considers the Residential MD/ADMM indicative of the ratio of residential maximum day to average day water usage in the Midwest. In IAWC's view, the Residential MD/ADMM is considered representative of residential customers in IAWC service areas for the purpose of developing the RDV factor for each respective rate area, based on the ratio of Residential MD/ADMM to System MD/ADMM. IAWC says the maximum day and maximum hour capacity factors for each IAWC rate area were developed using rate-area specific system and billing data. (IAWC Initial Brief at 108-109; Reply Brief at 79)

IAWC states that the RDV factor is one component in the calculation of maximum day and maximum hour capacity factors. Where Residential MD/ADMM data is not available, IAWC claims judgment considerations regarding the RDV factor are supported by the reasonableness of the resulting system diversity factors. IAWC says preliminary RDV factors were developed for each rate area based on a number of considerations. (IAWC Initial Brief at 109)

In reviewing the available Residential MD/ADMM data for the four Chicago Metro districts, IAWC determined that use of measured Residential MD/ADMM data in calculating an RDV factor for each rate area (based on the rate area's System MD/ADMM) corroborated the preliminary RDV calculations. As a result, IAWC believes that basing the proposed capacity factors on calculated Residential MD/ADMM was appropriate. In addition, IAWC insists this is the type of actual data that was to be used in the Demand Study to the extent it was available. IAWC also claims that direct measurement data available from the demand study conducted in 2007 in Docket No. 07-0507 supports the reasonableness of the Residential MD/ADMM results determined from daily usage data of Chicago Metro residential customers. (IAWC Initial Brief at 109-110)

Staff objects to the use of the Chicago Metro data to derive demand factors for the entire state, claiming that Chicago Metro maximum month ratios are used to produce peak month residential variations for all districts in Illinois. IAWC maintains that the use of the actual measured Residential MD/ADMM data from the four Chicago Metro service areas in calculating an RDV factor for each rate area (based on the rate area's System MD/ADMM) corroborated the preliminary RDV calculations. IAWC also repeats that the calculated RDV factor for each rate area, with the exception of Chicago Metro, is consistent with the range of diversity factor ratios (1.1 to 1.4) identified as acceptable in AWWA Manual. (IAWC Initial Brief at 110, Reply Brief at 79-80)

Staff also asserts that Chicago Metro usage is more weather-sensitive than in other districts, based on a comparison of each district's ratio of average daily usage for the peak month to residential daily usage for the year. Because the ratio for Chicago Metro is 147% and the ratios for the state's other districts range from 110% to 135%, IAWC says Staff reads the results to indicate greater weather-sensitivity in Chicago Metro than in other districts. IAWC insists that weather sensitivity cannot be demonstrated by simply comparing data from Chicago Metro to data from other rate areas. IAWC says while it recognizes that weather is a factor in determining customers' usage, it regards weather as only one contributing factor. Other factors that IAWC claims determine usage are general economic conditions in the service area, relative efficiency of fixtures and toilets, availability of automatic irrigation systems, yard size, type of grass, relative mixture of single family versus multifamily units, or customer preferences and priorities for yard maintenance. IAWC argues that there is no basis to conclude that Chicago Metro is more weather sensitive than other districts. (IAWC Initial Brief at 110-111, Reply Brief at 80-81)

According to IAWC, Staff also suggested that the use of Chicago Metro data is inconsistent with the Commission-approved methodology for the demand study. IAWC says Staff asserts that the "Commission-approved Methodology" did not constitute a detailed plan because it did not disclose the specific data to be used. (IAWC Initial Brief at 111) IAWC maintains that the methodology of the Capacity Factors Report was expressly approved by the Commission. IAWC also believes the methodology was detailed, and the use of actual residential demand data from the four Chicago Metro districts satisfies the Commission-approved methodology that actual data should be used “to the extent possible.” (IAWC Initial Brief at 111)

In IAWC's view, Staff's comparison of the use of Chicago Metro data to the use of Interurban data in Docket No. 07-0507 is inapposite, and should be disregarded. IAWC says Staff’s complaint is based largely on IAWC's comparison of actual Chicago Metro data with residential MD/ADMM values derived from the Company’s limited direct demand study of the Interurban district for Docket No. 07-0507. IAWC indicates that the data supplied by the Interurban study covered medium- and low-density residential areas, but did not cover high-density residential areas. According to IAWC, Staff seems to have interpreted IAWC’s reference to the Interurban study as an attempt to “tie” it to the Chicago Metro data. IAWC, however, insists that the Interurban study was cited only to show the reasonableness of the Chicago Metro data. (IAWC Initial Brief at 112; Reply Brief at 83)

IAWC says Staff believes that applying Chicago Metro’s residential ratios to produce maximum day demand factors for the entire state leads to anomalous results, particularly in the Pekin District. According to IAWC, the anomalous results for the Pekin District results were largely based on incorrect monthly billing data, which it has since corrected. (IAWC Initial Brief at 112)

Following Staff's observations, IAWC says it determined that the average day in the maximum month usage value for the Pekin system was overstated. IAWC states that this value was derived from monthly system billing information, which was initially assumed to be based on calendar months, but which was recently determined to actually represent more than 30 or 31 calendar days for the indicated maximum month. IAWC says that adjustments were made to revise the maximum month system data for each district, except those in the Chicago Metro rate area, the Interurban District and the Pontiac District, for which different data sources (not affected by billing period’s length of more than 30 days) were used. IAWC claims this resulted in changes to certain of the RDV values in the Capacity Factors Report and minor changes to the customer class capacity factors for the Alton, Cairo, Peoria, Streator, South Beloit, Champaign, Lincoln, Pekin, and Sterling districts.

IAWC says the changes were reflected in a revised Capacity Factors Report, IAWC does not consider these capacity factor changes to be material, and IAWC believes that revisions to its cost of service study are unnecessary. IAWC asserts that Staff agrees the revisions to key operating statistics for the non-Chicago districts in its rebuttal testimony eliminates Staff's argument for an alternative methodology for developing maximum day and maximum hour demand factors. (IAWC Initial Brief at 113)

IAWC indicates that Staff also objects to IAWC's proposed maximum day variations for the customer classes other than the residential class. In the Capacity Factor Report, IAWC says the maximum day variations for the commercial, industrial and other non-residential classes were established as a certain percentage of the RDV. Relying on data from the Sterling District in which the ratio of average day use for the maximum month to average daily usage for the year is higher for the commercial class than the residential class, Staff claims that IAWC should not assume the opposite, which is that residential customers vary more. Staff cites the AWWA Manual, which states that “[f]or residential customers, there is also likely to be some daily variation in usage throughout the maximum-month, although it is typically likely to be less than the commercial and industrial class variations.” (IAWC Initial Brief at 114) Staff also asserts that the Company’s maximum day capacity factor for the Other Water Utilities class is lower than for the residential class, while simultaneously calculating a higher ratio of the maximum day to the average day for the year for the residential class than for the Other Water Utilities class. (IAWC Initial Brief at 114)

IAWC contends that its conclusion that residential class variation is higher than other classes is supported by actual data as well as the AWWA Manual. IAWC asserts that despite the data from Sterling, the variations in daily demands within the maximum month are expected to be lower for commercial and industrial customers than for residential customers because their water usage is less influenced by weather conditions than residential customers. IAWC insists that actual data supports the assumption, that it is reasonable, and should be accepted. (IAWC Initial Brief at 114-115; Reply Brief at 81-82)

According to IAWC, Staff's comparison of the Other Water Utilities class to the residential class is also inapposite. IAWC asserts that the Other Water Utilities class in Interurban to which Staff refers is for wholesale water service and is typically a mixture of largely residential customers in suburban areas with some commercial and possibly light industrial customers that are served as one composite group (master metered). IAWC contends that this comparison is unrelated to, and does not contradict, the assertion that water usage for commercial and industrial customers is less influenced by weather than for residential customers. (IAWC Initial Brief at 115; Reply Brief at 82)

IAWC states that the methodology used in the Capacity Factors Report is considered an indirect demand study method, which derives demand factors based on analysis of accumulated system-wide data over several years. Staff, however, recommends that the Commission order a direct measurement demand study, which would entail placing time-sensitive meters on a sample of customers to measure their demands on a real time basis. IAWC believes such a study is not appropriate. IAWC asserts that such a study would be expensive, create possible operational concerns, and potentially produce unreliable data. IAWC says a direct study involves a potential impact on system costs and in the current economic environment it would be difficult to justify the additional cost of embarking on a course of directly measuring ratepayer demands to derive demand factors as it would entail adding further upward pressure on rates that have been rising for a number of years. (IAWC Initial Brief at 115-116)

IAWC asserts that Staff's objections to IAWC's use of the AWWA Manual to check the reasonableness of its results are misplaced. IAWC states that in both his direct and rebuttal testimony, Mr. Lazare relied on a hypothetical example from the AWWA Manual to refute IAWC's assertion that residential variation factors are greater than commercial and industrial class variation factors. IAWC indicates that Staff contends that there is no evidence to support IAWC's assertion that the example cited by Mr. Lazare is indeed hypothetical. IAWC argues that in so doing, Staff completely ignores Mr. McKinley's testimony that as a member of the AWWA Rates and Charges Committee, he assisted in the preparation of the current edition of the AWWA Manual and has first-hand knowledge about its development. IAWC says Mr. McKinley stated that the example cited by Mr. Lazare was for illustrative purposes only, and therefore did not rely on any actual utility data. According to IAWC, the data in the AWWA Manual relied upon by IAWC in demonstrating the reasonableness of its conclusions in the Capacity Factors Report is based on actual data. (IAWC Reply Brief at 83-84)

According to IAWC, Staff also asserts that IAWC's class variation factors for its districts in Illinois are undermined by a study conducted in the state of West Virginia. As an initial matter, IAWC complains that Staff offered no basis on which to conclude that a comparison between water usage in Illinois and West Virginia is warranted. Nonetheless, IAWC says Staff claims that the data collected in West Virginia showed that it may not always be reasonable to assume that the residential class has a higher ratio of peak day demands to average day demands than other classes. IAWC insists, however, that its assumption is supported by its use of actual data collected in Illinois, and further supported by the AWWA Manual. (IAWC Reply Brief at 84)

IAWC says Staff asserts that IAWC's maximum hour capacity factors are flawed solely because they are based on its maximum day demand factors. (IAWC Reply Brief at 84, citing Staff Initial Brief at 59) IAWC maintains that because the Capacity Factors Report methodology is sound, and its maximum day demand factors are well-grounded and reasonable, there is no basis on which to object to its maximum hour capacity factors.

IAWC believes Staff's recommendation that the Commission not accept IAWC's demand factors is groundless. IAWC contends that in its testimonial evidence and its Initial Brief, IAWC has demonstrated the reasonableness of its Capacity Factors Report and its results, all of which IAWC asserts were developed in accordance with the Commission-approved methodology of Docket No. 08-0463. IAWC says there is no basis on which to object to IAWC's Capacity Factors Report or its derived demand factors. IAWC argues that because it fully complied with the Commission's prior orders in Dockets Nos. 07-0507 and 08-0463, and produced a demand study in accordance with a Commission-approved methodology which provided reasonable demand factors for each district backed by actual data and expert opinions, those demand factors should be approved for use in this case. (IAWC Reply Brief at 84-85)

IAWC states that the indirect approach costs much less than the direct approach. IAWC adds that the indirect approach would avoid the expense of installing time sensitive meters, gathering data from those meters and developing demand factors from the data which would all be required to directly measure ratepayer demands. IAWC estimates that the cost of a direct study in Illinois, if ordered in this case, would be $1.86 million. IAWC states that water meters to measure individual customers are not typically configured in a manner to easily permit such measurements, and that their installation and maintenance cost approximately $20,000 per meter. (IAWC Initial Brief at 116; Reply Brief at 85-86)

IAWC believes an indirect study could derive demand factors more quickly and thereby would conform more closely to the expedited timeframe envisioned by the Commission for this case. IAWC says a direct measurement study would require a longer period of time, both to install recording meters, and to gather and analyze the readings therefrom. IAWC estimates that a direct study would require approximately 18 to 24 months to complete. (IAWC Initial Brief at 116-117)

IAWC also suggests there is potential that direct study data will be unreliable. If the Commission were to order a direct study in the present case, IAWC says short-term weather conditions could affect the results. If a demand study were to occur over a "wet year," IAWC claims the system peak might not occur, leading to inaccurate results. IAWC says that in periods of wet weather and economic downturn, both of which Illinois is currently experiencing, data produced under a direct study may not indicate actual peak usage conditions. IAWC also alleges that accuracy of data collected through individual meters is also undermined by the reliability of the equipment, which it claims is prone to failure due to the underground environment in which they are typically installed. Additionally, IAWC claims the volume of data that the meters record regarding maximum day and maximum hour usage can prove difficult to effectively manage, further undermining the usefulness of the readings. (IAWC Initial Brief at 117; Reply Brief at 85)

IAWC also asserts that direct demand studies suffer from the significant operational concerns related to diminished firefighting capabilities. IAWC states that direct studies may require isolation of parts of the distribution system, which would reduce the ability to deliver water to the customers in the event of a large demand like the need to fight a fire. IAWC also claims that in order to ensure that firefighting capacity would not be diminished in the event a demand study were ordered, the alternative would be to double or triple the cost of a demand study by installing two or three times the number of meters. (IAWC Initial Brief at 117-118; Reply Brief at 86-87)

IAWC says that while Staff cites a direct demand study conducted by the Company's parent in West Virginia, that study is inapplicable to a discussion of a direct demand study in Illinois. IAWC asserts that the West Virginia study was smaller in scope than what Staff has proposed for IAWC. IAWC says the West Virginia study consisted of only 50 metering points covering two districts, the results of which were then applied to other districts in the state. IAWC claims the Commission criticized a similar approach by the Company in its demand study in Docket No. 07-0507. According to IAWC, the cost of the outside consultant to the West Virginia study was $54,000. For a similar study to be conducted in Illinois, IAWC claims it would have to take many more meter readings, resulting in a five-fold increase to the cost of that aspect of the study alone. IAWC also asserts that the West Virginia study's cost was lessened by placing meters on pump stations serving primarily residential customers, few of which exist in Illinois. In IAWC's view, while Staff introduced the topic of the West Virginia study, it failed to address or dispute any of the points IAWC made attempting to demonstrate the study's inapplicability to Illinois. (IAWC Initial Brief at 118; Reply Brief at 87)

According to IAWC, Staff offered no specifics on how a direct study should be conducted in Illinois, and is not aware of the Commission requiring a water or wastewater utility to perform a direct measurement study. IAWC argues that because a direct study would offer no added benefit to Illinois ratepayers, and would add upward pressure to rates, the Commission should not order a direct study in the present case. (IAWC Initial Brief at 118-119; Reply Brief at 87-88)

IAWC also responds to IIWC. IAWC says IIWC claimed that the Capacity Factor Study did not measure capacity factors for the "pricing area" of Zone 1 with Champaign, and therefore the capacity factors used for it do not reflect its actual usage. IAWC says IIWC goes on to argue that the Company's proposed rate design and cost allocation for Rate Zone 1 with Champaign should be set aside in favor of a uniform percent change to all of Rate Zone 1 with Champaign's rate elements. (IAWC Initial Brief at 119)

IAWC contends, however, that because the Demand Study incorporates actual historical data and billing data from all of IAWC's service areas to develop capacity factors for each district, IIWC's complaint is baseless. IAWC says it has provided capacity factors for each district for which a rate increase is sought, which it claims is consistent with the order in Docket No. 07-0507. IAWC insists that the customer class capacity factors that the Commission sought were those for districts in which a rate increase was sought, not "pricing areas" as IIWC alleges. In IAWC's view, the fact that IAWC proposes to consolidate certain districts into rate Zone 1, for rate design purposes, does not change the fact that the appropriate approach was to develop capacity factors for each district. (IAWC Initial Brief at 119, Reply Brief at 88-89)

IAWC also believes that IIWC's concerns, although unwarranted, are easily addressed. IAWC says actual demand data for Peoria, Streator, Pontiac, and South Beloit Districts (collectively abbreviated as "SPSPSB" Districts), Sterling, and Champaign (the components of Zone 1 and Zone 1 with Champaign) was utilized in the Capacity Factor Report. IAWC claims the Capacity Factor Report contains sufficient information in Tables 2, 2a and 2b to determine revised cost allocation factors for SPSPSB, Zone 1 and Zone 1 with Champaign rate areas. IAWC asserts that this data can be combined and appropriately weighted in order to produce both cost allocation factors and capacity factors by customer class for the new Zone 1 and the proposed Zone 1 with Champaign. (IAWC Initial Brief at 120)

To further address IIWC's concern, IAWC says actual demand data for SPSPSB, Sterling, and Champaign (the components of Zone 1 and Zone 1 with Champaign) was combined and appropriately weighted in order to produce both cost allocation factors and capacity factors by customer class for the new Zone 1 and the proposed Zone 1 with Champaign. According to IAWC, the cost allocation factors do not significantly change between the various rate area configurations. IAWC alleges that the impact of adding Sterling to SPSPSB has a negligible impact on both the SPSPSB maximum day and maximum hour ratios. IAWC says adding Champaign to this relationship produces a maximum day ratio 1.6% greater than the former Zone 1 maximum day ratio and only 0.9% greater than the former Zone 1 maximum hour ratio. In IAWC's view, the relative changes between the various rate area configurations are minor and are generally what would be expected when considering the relative average daily usage and customer class capacity factors developed separately for SPSPSB, Sterling, and Champaign in the Capacity Factor Report. IAWC says these new system diversity factors all fall within the 1.10 to 1.40 range deemed acceptable by the AWWA Manual. IAWC suggests that IIWC's stated concerns, that the customer class capacity factors do not materially affect the results of the cost of service study, is not violated. (IAWC Initial Brief at 120-121; Reply Brief at 89, Reply Brief at 91-92)

2. Staff's Position

In Staff's view, the derivation of demand factors is a critical step in the cost allocation process because they must reflect costs in order to ensure that each class receives a reasonable share of system costs. According to Staff, the development of accurate demand factors has been a longstanding issue for IAWC, extending as far back as the Company’s 2002 rate case (Docket No. 02-0690). (Staff Initial Brief at 42)

Staff says IAWC responded by presenting a new set of demand ratios in its next rate case, Docket No. 07-0507, based on a demand study performed for the Interurban district. Staff indicates that the Commission found this approach problematic, concluding that IAWC did not comply with its directive in Docket No. 02-0690 because the Commission sought demand studies for all districts and IAWC performed a study for only one. Staff asserts that the deficiencies in the Company's analysis led the Commission to reject the use of the cost studies for designing rates in that case and to initiate a follow-up docket, Docket No. 08-0463, to address cost of service and rate design issues. (Staff Initial Brief at 42-43)

Staff suggests that IAWC overstates the importance of the fact that the Commission approved the Joint Motion in Docket No. 08-0463. Staff says IAWC goes as far as to say it in some way constitutes Commission support for the specific method IAWC proposes to estimate demand factors in this case. Staff disputes IAWC's contention that the Joint Motion presented a "detailed" plan for devising demand factors on an indirect basis. Staff also disagrees that the Commission's approval of that motion represents acceptance at some level for the specific method IAWC proposes to estimate class demand factors in this case. (Staff Initial Brief at 43-44; Reply Brief at 14-15)

According to Staff, the discussion in the Joint Motion falls far short of the standard for a "detailed" plan. Staff argues that it describes in general terms the method to be employed in estimating ratepayer demands. Staff claims the discussion of the proposed method for estimating relative class maximum hour demands is general as well. (Staff Initial Brief at 45)

In Staff's view, the general nature of the content shows that the motion clearly left to a later date the development of a specific plan for deriving these demand factors. Staff believes the Commission was only accepting a general plan to calculate these demand factors on an indirect basis. Since the Company's specific demand factor methodology was presented not in that motion, but rather in the demand study contained in the Company's initial filing for Docket No. 08-0463 and subsequently refiled in this proceeding, Staff insists there is no basis to conclude that the Commission has given prior approval, in any form, to IAWC's proposals in this case. (Staff Initial Brief at 46; Reply Brief at 19)

Staff also argues that the sole purpose of the Joint Motion was to seek clarification from the Commission whether IAWC could complete its demand study using an indirect methodology, in this case the IAWC Multi-Year Methodology, rather than directly monitoring meters at the time of peak usage. Staff states the Commission, in granting IAWC's motion, merely permitted it to complete its demand study using the indirect Multi-Year Methodology; Staff says it did not, and could not, pre-approve a demand study that had not yet been completed. (Staff Reply Brief at 15-16)

Staff's Initial Brief describes the method by which IAWC developed demand factors for residential and nonresidential classes on the IAWC system. (Staff Initial Brief at 46-49) Staff claims these class variations for nonresidential customers present a number of problems. Staff says one is that IAWC relies on old data from previous cases for its calculations. Staff also complains that there is no variation in these class variations from one district to the next. Staff states that, for example, IAWC "pegs" the commercial class variation at 85% of the residential level within the maximum month, regardless of their relative month-to-month variations in usage. Staff asserts that since these class variations within the maximum month play a key role in the development of both maximum day and maximum hour demand factors, IAWC's failure to justify the percentages it employs fails to demonstrate the reasonableness of the results obtained. (Staff Initial Brief at 49)

In Staff's view, the Company's proposed demand factor methodology presents a number of other problems that undermine its value for use in the ratemaking process. Staff believes the primary problem concerns the use of Chicago Metro maximum month ratios to produce maximum day demand factors for all classes in all districts. Staff asserts that IAWC has failed to demonstrate that the pattern of demands for these Chicago Metro customers accurately reflects the demands of IAWC customers on a statewide basis. (Staff Initial Brief at 49; Reply Brief at 17)

Staff believes that Chicago Metro usage is more weather-sensitive than other districts. According to Staff, a comparison of residential usage patterns for each of IAWC's Illinois districts indicates that Chicago Metro has a significantly higher ratio of average daily usage for the peak month relative to residential daily usage for the year than other districts in the state, 147% versus a range from 110% to 135% elsewhere. These figures suggest to Staff that Chicago Metro has a greater share of weather-sensitive demand than other districts in the state. Staff argues that Chicago Metro residential customers may exhibit greater daily variation in usage than residential customers in other districts not just on an annual basis but also during the course of the maximum month. (Staff Initial Brief at 50)

IAWC argues that these residential demands can be influenced by weather conditions, but they can also be influenced by general economic conditions in the service area, relative efficiency on fixtures and toilets, availability of automatic irrigation systems, yard size, type of grass, relative mixture of single family versus multifamily units, or customer preferences and priorities for yard maintenance. Staff believes IAWC's argument undermines its own position because many of the water uses it references, such as use of automatic irrigation systems, yard size, type of grass and customer preferences and priorities for yard maintenance, could be considered weather sensitive usage. (Staff Initial Brief at 50; Reply Brief at 17-18)

IAWC claims that residential customers may have higher maximum day ratios than other classes even when their ratio of average daily use for the month to average daily use for the year is lower. Staff says when commercial customers exhibit a higher ratio of ADMM to annual average day usage than residential customers, IAWC still expects their daily demands variations within the maximum month to be lower than for residential customers because their water usage is less influenced by weather conditions. Staff says IAWC goes on to argue that this conclusion is supported by the overall resulting capacity factors by class, the resulting diversity ratios, which are in the range of reasonableness, and the class capacity factors previously utilized by IAWC in its rate filings which have been accepted by the Commission in previous rate case dockets. (Staff Initial Brief at 51)

In its Reply Brief, Staff says IAWC disputes Staff's criticism of the assumption that residential customers exhibited greater demand diversity with the maximum month even when they has a lower ratio of maximum to average use. Staff contends that IAWC's arguments fail to address the point of Staff's reference to the AWWA Manual, which is that residential customers cannot simply be assumed to exhibit more demand diversity within the maximum month than other classes. Staff claims that IAWC's failure to respond serves to underscore the lack of support for this key tenet of IAWC's proposed demand factors in this case. (Staff Reply Brief at 20-21)

Staff asserts that the Company's methodology can produce some anomalous results. For example, Staff claims residential customers in the Interurban area have an average day for the peak month to the average day for the year ratio of 134.6% compared with a ratio of 164.5% for the Other Water Utilities class. According to Staff, this means that a much higher proportion of the annual usage by the Other Water Utilities class occurs during the peak month than for the residential class. Staff says IAWC assumes significantly less variability for the Other Water Utilities class for usage within the peak month to the point that its maximum day capacity factor falls below the residential level (190% vs. 195%), despite its much higher variation on a month-to-month basis. Staff states that IAWC, nevertheless, calculates a higher ratio of the maximum day to the average day for the year for the residential class than for the Other Water Utilities class. (Staff Initial Brief at 51-52)

Staff complains that IAWC does not adequately explain why usage patterns within the maximum month should conflict with usage from one month to the next. Staff asserts that if residential usage exhibited greater variability due to weather conditions, then a greater share of their annual usage could be expected to occur during the maximum month. According to Staff, the actual data indicates otherwise. (Staff Initial Brief at 52)

Staff says that in an effort to address this discrepancy, IAWC contends that residential water usage is influenced more by weather conditions than other types of usage than other customer classes and thus a greater share of annual residential usage naturally occurs in typically hotter and dryer summer months than other months. Staff claims this statement is unresponsive to the issue at hand, and does not explain why other classes have been found to consume a higher share of their annual usage in the maximum month than the residential class. Staff also complains that it does not explain why this perceived variability for the residential class should be manifested only within the maximum month. Until IAWC satisfactorily explains these discrepancies, Staff believes the Company's argument remains saddled with a fundamental contradiction. (Staff Initial Brief at 52)

Staff claims another problem concerns the Company's effort to compare the Chicago Metro numbers with the results of the 2007 Interurban demand study. Staff says the comparable Interurban figure is for only two of the three residential groups tested and does not include the high density (R1) customer group. According to Staff, how the inclusion of this customer group would impact the comparison has not been identified for the record. Staff also questions the usefulness of the Interurban data because the peak hour usage for the low density (R3) customers occurred at 4:00 A.M. In Staff's view, this usage pattern suggests that peak water demand for these customers must be driven by automatic lawn watering or some unknown use and leads Staff to question whether this behavior reflects residential water use throughout Illinois. (Staff Initial Brief at 52-53)

According to Staff, the exclusion of the high density group in the Interurban study and the fact that water demand by the low density group peaks at 4:00 A.M. make it difficult to understand how a comparison with the average of the medium and low density demand factors from that study supports the use of the Chicago Metro figures on a statewide basis. In addition, Staff says the 2007 study cited by the Company calculates a maximum hour ratio for the Interurban residential class of 6.0. In contrast, Staff states that the Company incorporates the Chicago Metro results to calculate a maximum hour ratio for Interurban, in this case of 2.45. Staff believes this difference further undermines the comparisons between the Chicago Metro and Interurban demand data. (Staff Initial Brief at 53)

Staff also questions the Company's reliance on diversity ratios that comport with the AWWA Manual to support its proposed demand factors. Staff claims IAWC uses the manual in a selective manner. Staff contends that when it supports IAWC's position, the Company is quick to cite the manual; however, when the manual comes into conflict, the Company states that it should be disregarded. Staff provides an example where Staff had cited the statement in the AWWA Manual that residential daily variation during the maximum month generally falls below the variations for the commercial and industrial classes. Staff says the Company responded by asserting the discussion in the AWWA Manual is largely related to a hypothetical example included in the manual that does not have the benefit of actual demand data, such as that used in the Revised Study from the Chicago Metro districts. (Staff Initial Brief at 53-54)

According to Staff, the AWWA Manual does not suggest this statement is limited to hypothetical situations. Rather, Staff quotes it to state that "[f]or residential customers, there is also likely to be some daily variation in usage throughout the maximum-month, although it is typically likely to be less than the commercial and industrial class variations." (Staff Initial Brief at 54, citing AWWA Manual at 298) Staff also argues that if this discussion in the manual can be dismissed as pertaining to hypothetical systems only, then the sections of the manual that IAWC relies to support its proposed demand factors can likewise be disregarded on the same basis. Staff also complains that the Chicago Metro data is data for the residential class only, while its demand variations for other classes reflect assumptions based on results from previous cases. (Staff Initial Brief at 54)

Staff complains that IAWC's use of data from these 2,161 Chicago Metro accounts on a statewide basis presents other problems. In Staff's view, it is inconsistent with the Order for Docket No. 07-0507 which Staff says criticized the Company for using data from one district, Interurban, to produce demand factors on a statewide basis. Staff asserts that in this case, the Company again proposes to apply demand patterns for customers in one district to usage by customers in other districts. Staff believes that the concerns expressed by the Commission in Docket No. 07-0507 about whether the demands in one district would be "reasonable proxies" for other districts apply in this case as well. (Staff Initial Brief at 54-55)

Staff asserts that there is conflicting evidence concerning demand factors for residential and non-residential customer from the results of the most recent demand study using time-sensitive meters conducted by an IAWC affiliate. Staff says that study measured 2008 demands for customers in West Virginia and found the maximum day and maximum hour demand factors for Residential, Commercial and Public and Industrial classes to be virtually the same. In Staff's view, this indicates it may not always be reasonable to assume that the residential class will have a higher ratio of peak day demands to average day demands than other classes. Staff contends that while this recent data from West Virginia may not be appropriate for developing demand ratios for the IAWC districts, there is also a lack of evidence to use the demands of the four Chicago Metro areas in developing IAWC's proposed ratios across Illinois. (Staff Initial Brief at 55; Reply Brief at 21-22)

Staff says IAWC's witness said it was difficult to comment on the applicability of the West Virginia data because he is not familiar with the customers that compose the various customer classes nor the study related to determining the indicated demand factors. Staff complains that this lack of familiarity did not prevent IAWC's witness from speculating about why the results of the study should not be considered applicable to the IAWC system. According to Staff, IAWC posits that if residential customers have small yards or do not irrigate their yards as much as residential customers in other regions, while the commercial or public customer class includes such high demand customers as golf courses or high schools and colleges with irrigated football or other playing surfaces, it is possible for such customers to exhibit higher demands than the residential customer class. Staff indicates that IAWC then states that it is not fully aware of the circumstances related to the variations in class demands for the West Virginia situation, but it is clear that the class characteristics there are quite different from those experienced in the Demand Study performed for the Company's Illinois systems. (Staff Initial Brief at 55-56)

Staff argues that if IAWC's witness is unfamiliar with the West Virginia study, then he has no basis on which to compare the class characteristics in that study with Illinois or anywhere else for that matter. Staff also objects to an IAWC witness' lack of knowledge, while the West Virginia study was prepared by another Company witness in this case, Mr. Paul Herbert. Staff contends that its witness is able to gather information concerning this study, and there is no reason why a Company witness should be unable to do the same. Staff insists that it is unreasonable under these circumstances for the IAWC witness testifying on this matter to plead ignorance about the study. (Staff Initial Brief at 56-57; Reply Brief at 23)

The evidence, in Staff's view, indicates that the Company's methodology for developing demand factors should not be used to design rates in this proceeding. Staff believes this even applies to the Chicago Metro district where these 2,161 residential accounts are situated. Staff says that Chicago Metro is included because questions remain concerning the differences between measured demands for customer classes on a monthly basis and assumptions about variations in demand on a daily basis over the maximum month. Staff reiterates that the Chicago Metro Residential class has a lower ratio of average maximum month daily demand to average annual daily usage than the Commercial class; i.e., 146.7% vs. 164.6%. Despite the fact that this monthly variation is lower for the Residential class than the Commercial class, Staff says the Company assumes that variation within the maximum month is greater for the Residential class than for the Commercial class. It is Staff's position that the Company has failed to provide sufficient evidence to support this assumption and, therefore, has failed to demonstrate the reasonableness of its proposed demand factors for the Chicago Metro district. (Staff Initial Brief at 57)

Staff believes that the maximum hour demand factors developed by IAWC are problematic as well. Staff says the residential factors were developed as a multiple of three factors: the maximum day capacity factors for the residential class in each district; the ratio of the system maximum hour pumpage divided by the average hour pumpage for the maximum day; and the residential hourly variation. According to IAWC, this factor adjusts the system's coincidental maximum hour demands to recognize that the system coincidental maximum hour demands are not equally shared by all customer classes. (Staff Initial Brief at 57-58) Staff's Initial Brief also describes how the residential and nonresidential maximum hour demand factors were developed. (Staff Initial Brief at 58-59)

In Staff's view, the key problem with the maximum hour capacity factors developed by IAWC lies with the starting point, the maximum day demand factors for each class which Staff believes have been show to be fundamentally flawed. Staff contends that the inclusion of these maximum day demands in the Company's calculation of maximum hour factors makes them problematic and renders them unsuitable for ratemaking in this case. (Staff Initial Brief at 59)

Staff believes that while the demand factors proposed by IAWC are not appropriate for ratemaking based on the evidence presented in this case, no reasonable alternative has been developed that can be used to derive an accurate set of cost study results. (Staff Brief at 60)

Staff says it did develop an alternative demand factors methodology in direct testimony for this case. According to Staff, that approach was based on the operating statistics presented in IAWC's direct case which indicated that the application of Chicago Metro residential ratios to other districts produces residential usage variations over the maximum month significantly above the variation in pumpage for the system as a whole over that same maximum month. Staff says the data indicated that maximum month daily variation is significant for the residential class but minimal for the system as a whole which meant that other customers must use significantly less than average usage on the maximum day to balance the residential maximum day usage calculated by IAWC. Staff considered this an unlikely scenario and developed an alternative demand factor approach which addressed this discrepancy. (Staff Initial Brief at 60)

According to Staff, IAWC stated in rebuttal that the operating statistics on which the alternative Staff approach was based are inaccurate. IAWC states the Company reexamined those statistics in response to the Staff discussion of these conflicting variations over the maximum month and discovered that it had overstated the levels of average daily deliveries for the maximum month in a number of operating districts. Staff indicates that IAWC found it necessary to revise these average operating statistics for all districts, save Chicago Metro, Interurban and Pontiac. Staff says these revisions increased the daily variations during the maximum month for all IAWC systems other than Chicago Metro. (Staff Initial Brief at 60-61)

Staff states that these revisions eliminated the inconsistencies between the variations for the system and the residential class for the non-Chicago districts over the maximum month. Staff's alternative demand factors were designed to address the apparent discrepancies in the maximum month daily variations for residential class for Pekin and other districts on the IAWC system. According to Staff, to the extent that the revisions to the data eliminate these discrepancies, the justification for Staff's alternative demand factors disappears. (Staff Initial Brief at 61) Staff adds that it performed its analysis in direct testimony based on the operating data provided in IAWC's initial filing. When that data was fundamentally revised for all districts save Chicago Metro, Staff says it undermined the basis for Staff's analysis and provided too short a time frame, approximately a month, for rebuttal in which to perform a revised analysis. (Staff Reply Brief at 20)

Staff insists that the fact that its alternative methodology is no longer applicable does not make the Company's proposed maximum day and maximum hour demand factors a more reasonable alternative. Staff believes the fundamental problems with those factors remain and they are of sufficient magnitude to undermine the accuracy of the Company's cost study results. (Staff Initial Brief at 61, Staff Reply Brief at 20)

In its Reply Brief, Staff says IAWC presents an interesting spin on the faulty data problem which plagued its filing in this case and impeded Staff's effort to develop an alternative set of demand factors. According to Staff, IAWC seeks to turn this negative into a positive by stating that the significant revisions to the data in rebuttal meant the anomalous results found by Staff witness Lazare regarding residential usage variations over the maximum month for Pekin have been fully resolved. Staff says IAWC also states that following Mr. Lazare's observations, the Company determined that the average day in the maximum month usage value for the Pekin system was overstated. Staff contends that while implying that this problem is limited to the Pekin system IAWC acknowledges that adjustments were made to revise the maximum month system data for each district, except those in the Chicago Metro rate area, the Interurban District and the Pontiac District, for which different data sources (not affected by billing periods length of more than 30 days) were used. In Staff's view, the extent of these adjustments is an indication that data problems existed throughout the state. (Staff Reply Brief at 19-20)

Staff believes the evidence in this case calls into question the Company's reliance on an indirect approach rather than direct measurement to calculate demand factors. Staff asserts that the indirect approach is a less costly alternative because direct measurement through the use of time-sensitive meters for a sample of customers can be a costly option. Staff says that cost is multiplied if the Company is required to separately measure demands in each of its districts as the Commission has ordered. When asked in discovery to estimate the cost of developing demand factors through the direct measurement of ratepayer demands, Staff indicates that the Company provided a figure of $1.86 million for such an analysis. (Staff Initial Brief at 62)

Another advantage of the indirect approach is time, Staff avers. Staff indicates that direct measurement of ratepayer demands requires installing meters before the summer starts and then collecting data until the summer season ends. In contrast, Staff says an indirect measurement can be performed at any time based on data that already exists. In this case where the Commission has encouraged the Company to produce results on an expedited basis, Staff believes the indirect method offers a clear advantage. (Staff Initial Brief at 62)

Staff claims the advantage of direct measurement, if performed correctly, is accuracy. Staff says the indirect calculations of maximum day and maximum hour demand factors presented by the Company employ judgments about the behavior of customer classes within the maximum hour and maximum day that may or may not conform to reality. In Staff's view, the most accurate way to test the validity of these judgments would require some form of directly measuring ratepayer demands. (Staff Initial Brief at 62)

Staff indicates that there is a tradeoff between cost and accuracy. In the current economic environment, Staff says it could be difficult to justify the additional cost of embarking on a course of directly measuring ratepayer demands to derive demand factors. Staff states that would entail adding further upward pressure on rates that have been rising for a number of years. At the same time, Staff expresses concern that the indirect methodologies presented so far in this case present problems and thereby undermine the value of the Company's cost of service study results. In Staff's view, the lack of a viable alternative at this juncture is a reason to consider moving forward with a direct study despite the potential impact on system costs. (Staff Initial Brief at 63)

Staff does not find the Company's arguments against a direct study to be persuasive. Staff concedes that an indirect methodology is the faster and less expensive alternative. The problem, Staff insists, lies with the accuracy of the results obtained under this approach. Staff argues that as the evidence in this case shows, the deficiencies in IAWC's methodology are of sufficient scale to undermine the value of the results. In Staff's view, it is not clear how IAWC ratepayers benefit from a cheaper study that produces meaningless results. (Staff Initial Brief at 64; Reply Brief at 24)

With regard to the time and expense for a direct demand study, Staff claims it is difficult to reconcile the arguments about costs with the actual expenses IAWC's parent company, American Water, has recently incurred in performing a demand study based on direct measurement. Staff says the Company initially indicated that the direct measurement demand study for West Virginia American Water Company was performed in 2008 at a cost of $27,293. Staff claims this is a far cry from the $1.86 million cited by IAWC to perform an Illinois study. (Staff Initial Brief at 64)

Staff says the Company indicated in surrebuttal that the $27,293 it had previously identified is incorrect. According to Staff, the Company elaborated on the cost, stating the cost for the study alone was over $54,000, which included only the data analysis and preparation of the report for the Company's two service areas. Staff says IAWC further asserts that there were also considerable expenditures for equipment and Company personnel time that are not included in the cost. (Staff Initial Brief at 64-65)

Staff complains that when the Company corrects numbers at the surrebuttal stage of the process, it is difficult to understand the changes that are made and to ascertain the accuracy of the revised figure within such a short timeframe. Nevertheless, Staff asserts that the alternative figure provided, $54,000, still falls far short of the $1.86 million cited to perform an Illinois study and IAWC has failed to bridge the cost gap with the West Virginia study. (Staff Initial Brief at 65; Reply Brief at 23-24)

Staff indicates that IAWC asserts there are operational and cost concerns associated with a direct measurement study. IAWC says that in order to be assured that the study encompasses usage under peak conditions, the study may have to be conducted over a number of years. Staff notes that IAWC fails to identify any operational or cost concerns with the West Virginia study it conducted. Staff also asserts that IAWC fails to reconcile this statement about conducting a study over a number of years with its experience of performing a demand study in West Virginia within a single year. Staff contends that this makes it difficult to ascertain whether the problems cited are valid. (Staff Initial Brief at 65; Reply Brief at 24)

IAWC contends that its demand factors should be considered reasonable because the results are 'typical of the range of capacity factors that IAWC has observed in other water utilities, and, when compared to system coincidental demands, produce diversity ratios generally in the range considered reasonable by the AWWA Manual. Staff contends that IAWC's argument boils down to recommending that the Commission should not be bothered that its proposed factors are based upon a host of unproven assumptions and unsubstantiated claims. Staff suggests IAWC wants the Commission to believe that as long as the diversity ratios fall into a desired range, the Commission can be assured that the results are accurate. Staff says this is a theme that the Company returns to often in its Initial Brief. Staff contends that when confronted with shortcomings and contradictions in its analysis, IAWC does not respond directly, but rather reflexively insists that the demand factors must be reasonable because the diversity ratios fall into a desired range. (Staff Reply Brief at 16-17)

In summary, Staff believes the Company has failed to make a compelling case for the use of its indirect calculation methodology. Given the importance to all rate classes of allocating costs fairly and accurately, Staff recommends that the Commission adopt a direct demand calculation approach that accurately calculates ratepayer demands on the IAWC systems. (Staff Initial Brief at 65) In its Reply Brief, Staff responds to IAWC's complaint that Staff failed to provide specifics on how a direct demand study should be performed. Staff asserts that IAWC certainly has the expertise to perform such a study itself. Staff says an IAWC witness in this case, Mr. Herbert, performed the last direct demand study undertaken by a Company affiliate. Staff argues that since IAWC already is capable in this regard it is not clear why it would consider Staff's input essential or even necessary to perform a direct demand study in Illinois. (Staff Reply Brief at 24-25)

3. IIWC's Position

The Company's cost of service study uses the Base Extra Capacity method to functionalize, classify and allocate costs to its customer classes. IIWC says this method is widely accepted in the industry. IIWC states that this method functionalizes utility plant investment according to the role that investment plays in providing water service: water supply, pumping, treatment, transmission, distribution, metering and billing. IIWC indicates that then the cost of that investment is classified into cost categories that reflect how the costs are incurred: base, or average day rates of flow; Extra Capacity-Maximum Day; and Extra Capacity-Maximum Hour rates of flow; and customer-related costs. IIWC complains, however, that the Company's study in this case is not based on demand factors specifically designed for Rate Zone 1 and Rate Zone 1 with Champaign.

According to IIWC, the Company's study in this case suffers from the same deficiency as the Company's study in its last rate case. IIWC asserts that the Commission previously directed the Company to provide updated capacity factors for each of its rate districts. IIWC insists that the capacity factor study presented in this case does not estimate capacity factors for Rate Zone 1, or Rate Zone 1 with Champaign. (IIWC Initial Brief at 40-41)

IIWC claims that in its surrebuttal testimony, the Company acknowledged that it did not offer demand factors for Rate Zone 1 and Rate Zone 1 with Champaign until the Company filed rebuttal testimony. IIWC contends those rebuttal demand factors were not used by IAWC in its cost of service study in this case. In IIWC's view, the Company's cost of service study did not reasonably reflect capacity factors that reflect the actual rate zones for which the cost study is used. (IIWC Initial Brief at 41)

IIWC maintains that the Company's cost of service study in this case suffers from the same deficiency as the study presented by the Company and rejected by the

Commission in the last rate case. Under such circumstances, IIWC believes the Commission should not use the Company's cost of service study in this case for the purpose of determining the revenue allocation and should direct that any rate increase approved be implemented on an equal percentage across-the-board basis. IIWC points out that Staff recommended the Commission not accept the Company's cost study and recommends that rates be adjusted by an equal percentage change to rates across all rate classes. (IIWC Initial Brief at 41)

IIWC says IAWC argues that Rate Zone 1 and the Rate Zone 1 with Champaign rate areas are pricing districts, and it was not required by the Commission to establish class capacity factors for pricing areas. According to IIWC, whether or not IAWC was required to establish capacity factors for "pricing areas" is irrelevant. IIWC states that Company witness Mr. Herbert provided cost of service studies for each company "rate area." The rate areas that were the subject of the individual cost of service studies included, but were not limited to, Rate Zone 1 (the Southern, Peoria, Streator, Pontiac and South Beloit Districts) and Rate Zone 1 with Champaign. IIWC says the purpose of these studies was to provide an indication of the cost of serving each customer class, in each rate area for which a study was performed. Based on these studies, IIWC indicates that IAWC presented revenue allocations for each customer class, and the rates that produce the allowable revenue requirement for each of the rate areas that was the subject of a cost of service study. (IIWC Reply Brief at 26-27)

IIWC states that IAWC argues that capacity factors for Rate Zone 1 and Rate Zone 1 with Champaign can be calculated. According to IIWC, the Company's argument is nothing more than an admission that such factors have not been calculated and included in the applicable cost of service studies as IIWC has stated. IIWC asserts that the fact that capacity factors can be calculated does not mean they were calculated and used in the Company's cost study. (IIWC Reply Brief at 27-28)

In IIWC's view, IAWC's argument that it has calculated allocation factors and capacity factors for Rate Zone 1 and Rate Zone 1 with Champaign, is without merit because the capacity factors IAWC now says it calculated, are not the capacity factors used in IAWC's cost of service studies. (IIWC Reply Brief at 28)

IIWC also believes that IAWC argument, that IIWC's concerns about class capacity factors do not materially affect the results of its cost of service study, is also without merit. IIWC insists that IAWC did not use the rate class specific capacity factors in its cost of service for Rate Zone 1 with Champaign, and it is therefore not possible for IAWC to measure the impact on the study accuracy. IIWC insists that IAWC's cost of service studies are not reliable and should be rejected. (IIWC Reply Brief at 28)

B. Cost of Service Analysis

1. IAWC's Position

IAWC submitted an updated cost of service study ("COSS") in the present case, which it says is in accordance with the requirements of the Order in Docket No. 07-0507 that the Company provide a COSS in this case. The COSS is an updated version of the cost allocation studies performed in Docket No. 08-0463, which was based on the revenue requirements previously approved by the Commission in Docket No. 07-0507. IAWC states that for this case, the Company's COSS was updated to utilize the revenue requirements proposed in this case. The Company performed cost allocation studies for the Champaign, Chicago Metro Water, Lincoln, Pekin, Zone 1 (the former SPSPSB and Sterling), Zone 1 with Champaign, and Chicago Metro Wastewater rate areas. IAWC notes that Staff agrees the COSS conforms to the approach presented in the AWWA Manual and concludes that it provides a reasonable basis for allocating costs in this proceeding. (IAWC Initial Brief at 121)

In performing the COSS, the Company used the base-extra capacity method. This method allocates the cost of water service in proportion to the various classifications' use of water, facilities and services. IAWC indicates that the base-extra capacity method was approved for use in IAWC's COSS by the Commission in Docket No. 08-0463. IAWC alleges that this method is long-recognized in Illinois, and the Company used it in previous cases. IAWC claims it is also recognized in the AWWA Manual, and is widely accepted as a sound method of allocating the costs of water service. (IAWC Initial Brief at 121)

IAWC says costs in the base-extra capacity method are allocated based on various specific factors, depending on the nature of the cost. Costs that vary with the amount of water consumed are considered base costs, and are allocated in direct proportion to daily average consumption. Costs associated with meeting usage in excess of the average, most often maximum day requirements, are allocated partially as base costs in proportion to average daily consumption, and partially as customer classifications as maximum day extra capacity costs in proportion to maximum extra capacity, and, for certain pumping stations and transmission mains, partially as fire protection costs. Storage facility costs and the capital costs of distribution mains, which are designed to meet maximum hour and fire demand requirements, are allocated on the basis of average consumption, maximum hour and fire demand requirements. Similarly, fire demand costs are allocated in proportion to the relative potential demands on the system of the system's hydrants.

Costs for pumping facilities and the operation and maintenance of mains are allocated on the combined bases of maximum day and maximum hour extra capacity. Meter costs are allocated to customer classifications in proportion to the meter equivalents of the sizes and quantities serving each class. Customer accounting, billing and collecting costs are allocated based on the number of customers in each classification, and costs for meter reading on the basis of metered customers.

Administrative and general costs are allocated on the basis of allocated direct costs, as is the cost of cash working capital, though different factors are used for these categories. Finally, IAWC says depreciation accruals are allocated on the basis of the function of the facilities being depreciated for each depreciable plant account. (IAWC Initial Brief at 122)

IAWC states that the base-extra capacity method uses non-coincident peak demand to allocate costs, which IAWC claims is more exact and more cost-efficient than using coincident peak demands. According to IAWC, allocating costs based on coincident peak demand involves a great deal of subjectivity and guess-work, as it is not possible to determine the respective classifications' demands on the system based on the coincident peak demand. Furthermore, IAWC contends that designing a system based on non-coincident peak demands, which relies on system diversity, allows for construction of a smaller and more cost-efficient system. IAWC asserts that because all classes benefit from the cost-efficiency created by utilization of system diversity, costs are therefore shared proportionately based on each class' respective non-coincident demand. (IAWC Initial Brief at 122-123)

In IAWC's view, because of the inherent flaws in use of coincident peak demand, that method is not used in Illinois or any other jurisdiction. IAWC insists the base-extra capacity method and its component use of non-coincident peak has long been used in Illinois, and is considered an acceptable means of allocating costs. IAWC says that among the weaknesses of using coincident peak demands are its relatively high cost and its inexactitude. IAWC also says neither the Company nor Staff can point to any water or wastewater utility commission ordering a cost of service study based on its use. (IAWC Initial Brief at 123)

With respect to the future use of the base-extra capacity method, Staff complained that, although the Company allocates costs to ratepayers based on non-coincident peak demands, it uses coincident peak demands in allocating its own costs. Staff refers in particular to water treatment plant in the Champaign service area. Staff requests that the Commission order the Company to prepare a COSS using coincident capacity factors in its next rate case. IAWC asserts that this proposal is entirely without precedent, as there is no evidence in the record of any water or wastewater utility in Illinois, or any other jurisdiction, performing a cost of service study based on coincident capacity factors. (IAWC Initial Brief at 123; Reply Brief at 90-91)

In IAWC's view, Staff's objections to the COSS, base-extra capacity method and use of non-coincident peak are inconsistent with the history of Staff supporting such cost of service studies. IAWC says that in Docket No. 07-0507, Staff supported the Company's use of the base-extra capacity method, which was based on non-coincident peak demands. According to IAWC, in its direct testimony Staff supported the COSS, which uses the base-extra capacity method, conforms to the AWWA Manual and provides a reasonable basis for allocating costs in this proceeding. (IAWC Initial Brief at 124)

IAWC asserts that the benefit of using non-coincident peak demand is that it recognizes the diversities of demands of various classes, allowing for construction of a smaller, more efficient system. To support the Company's COSS methodology, IAWC cites the AWWA Manual's statement that in using base-extra capacity and non-coincident peak, "all classes share proportionately in the economies of scale and cost savings of this smaller, integrated, and diverse system." (IAWC Initial Brief at 124; Reply Brief at 91)

IAWC says while Staff is correct that the Champaign water treatment plant was built to meet collective system demand, it is incorrect in suggesting that costs should therefore be allocated based on coincident peak demand. IAWC argues that while the plant has enough capacity to meet diverse class peak demands whenever they may occur, every class served by it benefits from system diversities. IAWC believes costs should be shared proportionately based on each class' non-coincident demands. IAWC says that although Staff argues that a cost of service study should focus on allocation of costs rather than sharing of benefits, it fails to appreciate that the smaller, more diverse system allowed by the use of non-coincident peak demand allocation leads to the shared benefit of lower costs. (IAWC Initial Brief at 124-125)

IAWC insists that estimating individual class peak demands on the coincident peak day would be much more subjective than estimating non-coincident demands. IAWC says that for non-coincident demands, one can study the pattern of usage for each class based on actual billing records and system delivery over the course of several months of data. In using coincident peak demand, IAWC asserts that one would have to estimate what each class' usage was on a specific day in order to allocate costs. IAWC believes this task would be especially difficult should the peak day occur on a weekend. IAWC says Staff failed to counter this fact, other than to offer its proposal that the Commission order a direct demand study. (IAWC Initial Brief at 125; Reply Brief at 90-91)

In its Reply Brief, IAWC also states that Staff's position on the COSS is not entirely clear. Staff appears to believe the COSS is reasonable, stating in its Initial Brief, "Staff has found that the structure of the Company's proposed cost of service study and the allocators chosen for that study to be reasonable for this proceeding" and "the key argument that makes the base-extra approach acceptable for ratemaking in this case is its consistent use in previous water rate cases in Illinois. (Staff Ex. 6.0 at 6) . . . For this reason, Staff finds it acceptable for use in this case. The specific allocation factors chosen by the Company for its cost study also appear to be reasonable." (IAWC Reply Brief at 89-90, citing Staff Initial Brief at 66-67)

IAWC also notes that Staff witness Mr. Lazare testified that the COSS conforms to the approach presented in the AWWA Manual and "therefore provides a reasonable basis for allocating costs in this proceeding." (Id., citing Staff Ex. 6.0 at 2) IAWC says Staff's only concerns with the COSS appear to be related to its concerns with demand factors, discussed above.

IAWC also responds to IIWC. IIWC asserts that the Company's allocations for purchased power cost do not reflect seasonal power price differentials, and that the AWWA Manual supports its proposal to allocate power costs to extra capacity, using the COSS's Factor 6. IAWC argues that IIWC's proposed allocation of purchased power costs would lead to cost misallocations, however, and must be rejected. IAWC states that IIWC's proposal is based on the contention that IAWC's purchased power costs vary greatly by season, and rise in periods of peak water demand. IIWC therefore suggests that Factor 6, which is tied to peak demands, produces a better allocation. (IAWC Initial Brief at 126)

IAWC contends that the allocation of purchased power costs using Factor 1 correctly reflects actual power costs. IAWC says it has obtained contract pricing for 80% of its test year electric supply. The new power contracts give IAWC fixed pricing throughout the contract term, rather than seasonal rates as were charged with the previous contracts. According to IAWC, there are no seasonal price differentials for power supply costs. (IAWC Initial Brief at 127; Reply Brief at 92)

In addition, IAWC asserts that using Factor 6 would allocate far too much power cost to the extra capacity function. IAWC says it reviewed a sample of power bills for the Company and analyzed the portion of the demand charge compared to the total bill for each month and then annualized the lowest demand charge for the year. According to IAWC, the difference between the annualized demand charge for the minimum month, compared to the actual demand charges for the year, was only 3.0% of the total annual power bill. IAWC claims that allocating this small portion of the power costs on an extra capacity basis would result in very minor changes to the cost allocation. IAWC believes that IIWC's recommendation should be rejected because the appropriate factor to allocate power costs is Factor 1, based on average daily usage. Because the Company's purchased power costs do not vary seasonally as IIWC incorrectly assumes, the use of Factor 6 would lead to an over-allocation of 32% of power costs to extra capacity. (IAWC Initial Brief at 127; Reply Brief at 92-93)

IAWC also asserts that IIWC misreads the AWWA Manual. IAWC says the AWWA Manual directly addresses purchased power costs and states that "power costs are allocated principally to the base cost component and suggests that demand charges can be allocated to extra capacity to the degree that they vary with pumping requirements." According to IAWC, the important phrase, however, is "to the degree it varies with demand pumping requirements." IAWC argues that because there is an electric demand charge every month, regardless of the level of use, it is not the total demand charge that should be considered extra capacity, but only the degree that the demand charge varies with pumping requirements. IAWC recommends that the Commission reject IIWC's proposal because IIWC provides no basis for its suggestion. (IAWC Initial Brief at 127-128; Reply Brief at 93)

2. Staff's Position

In Staff's view, there are two key steps to allocating system costs among rate classes. The first entails selecting appropriate allocators for system costs and the second concerns the way that the individual allocators are calculated. Staff avers that for cost study results to be reasonable, not only must the set of proposed allocators accurately reflect costs, but those allocators should be developed in an accurate manner. Staff asserts that if either step falls short, then cost allocations will be inaccurate and the results of the study will be flawed. Staff has found that the structure of the Company's proposed cost of service study and the allocators chosen for that study to be reasonable for this proceeding. However, as discussed above, Staff does not agree with the way those demand factors are developed. (Staff Initial Brief at 65-66)

IAWC uses the base-extra capacity method to allocate system costs to the residential, commercial, industrial, other public authorities, sales for resale (including large sales for resale), private fire protection and public fire protection classes. Staff states that this approach is comparable to the average and excess method for allocating gas and electric utility costs. Staff says that average demands are used to allocate the base portion of system costs and non-coincident peak ("NCP") demands are used for the "extra" component of costs meeting the demands that exceed the average. NCP demands are the maximum demands for each individual customer class during the year. (Staff Initial Brief at 66)

IAWC supports the use of NCP demands to allocate "extra" costs by citing the discussion in the AWWA Manual which focuses on the benefits to the system of customer diversity. Staff says the argument notes that if separate systems had to be built for individual customer classes, each would have to be sized to meet the peak demands of that class. According to Staff, however, constructing a system to collectively serve all classes allows the total capacity built to be downsized because of customer diversity. Staff says the base-extra method considers the NCP demands an appropriate measure of these diversity savings for rate classes. Staff indicates that IAWC further contends that the base-extra approach is a recognized method for allocating water costs in proportion to the classifications' use of the commodity, facilities, and services and that this approach has been used in previous cases. (Staff Initial Brief at 66-67)

According to Staff, the key argument that makes the base-extra approach acceptable for ratemaking in this case is its consistent use in previous water rate cases in Illinois. Staff says that by consistently adopting this approach the Commission has signaled acceptance of the base-extra methodology for water cost of service studies. For this reason, Staff finds it acceptable for use in this case. The specific allocation factors chosen by the Company for its cost study also appear reasonable to Staff. Staff says that approach features the allocation of costs such as purchased water, purchased electric power, treatment chemicals and waste disposal according to average usage because these are base costs incurred in proportion to the amount of water consumed. The Company indicates that costs such as other source of supply, water treatment and transmission costs are sized to meet peak demands and consequently are allocated by a combination of factors, including base average daily demands, maximum day extra capacity, and according to fire protection costs for certain pumping stations and transmission mains. (Staff Initial Brief at 67)

Staff indicates that storage costs and distribution mains are allocated by a combination of average daily demands and maximum hour extra demand including fire demand which these facilities are designed to serve. Fire demands are allocated between public and private fire protection according to their relative potential demands on the system. (Staff Initial Brief at 67-68)

Staff states that IAWC's proposed study allocates pumping facilities costs and mains operating and maintenance by both maximum day and maximum hour extra capacity because these facilities serve both functions. Costs for meters and services are allocated by "equivalents" in terms of size and quantities serving each customer class. Public fire hydrant costs are assigned to public fire protection. Customer costs such as customer accounting, billing and collecting are allocated on a customer basis while meter reading are allocated by the number of metered customers. Finally, Staff says administrative and general costs are allocated in a variety of ways according to allocated direct costs. (Staff Initial Brief at 68)

For public fire costs, Staff indicates that the Company's proposed studies include assumptions concerning the level of fire flow for each district. These assumptions range from a high of 16,000 gallons per minute ("gpm") for 10 hours for Zone 1 down to 2,500 gpm for 2 hours for Lincoln, with other districts falling between these extremes. The Company states that the flow data for all systems except Zone 1 were based on hydrant flow data from Insurance Services Office, Inc. For Zone 1, Staff says the Company relied on flow requirements recommended by the National Board of Fire Underwriters (now the American Insurance Association). For calculating durations, the Company relies on the Grading Schedule for Municipal Fire Protection from Table 4 of the Insurance Services office which was furnished by the Company. These fire flows appear reasonable to Staff because they are based on generally accepted sources of information. In addition, Staff has not identified any shortcomings in IAWC's calculation of these demands. (Staff Initial Brief at 68-69)

On an overall basis, Staff avers that the Company's proposed allocators for system costs should be considered reasonable because they are consistent with both Commission precedent in Illinois and with cost allocation principles presented in the AWWA's Manual.

Staff does, however, recommend that the Company be ordered in its next rate case to prepare a cost of service study based upon coincident capacity factors. (Staff Ex. 6.0 at 7) Staff states that such an approach would employ coincident peak demands to allocate system costs that are jointly used by multiple rate classes. This approach, which Staff indicates is described in Appendix A of the AWWA Manual, would more accurately reflect how system costs are incurred and send better price signals to ratepayers concerning the impact of their demands on system costs. (Staff Initial Brief at 69)

While acceptable for this proceeding, Staff believes the base-extra methodology is beset by a fundamental problem which calls into question its use over the long term. Staff says the problem is the reliance on NCP demands to allocate demand-related costs. According to Staff, the evidence indicates that many key facilities are built to meet the collective demands of all ratepayers. Thus, Staff asserts that their size is shaped by coincident peak ("CP") demands which are the demands by all classes at the time the system peaks. In Staff's view, this would indicate that the Company's exclusive use of NCP demand to allocate these costs is misplaced. (Staff Initial Brief at 69)

According to Staff, the new water treatment plant constructed to serve the Champaign service territory is designed to serve not just individual rate classes but all classes in the district on a collective basis. Staff says the plant must be of sufficient size to meet the collective peak demands of all rate classes in the district, rather than the demands of any individual class. Thus, Staff believes CP demands, rather than NCP demands, are the important factor to consider in allocating the plant's costs. (Staff Initial Brief at 70)

IAWC, Staff states, argues against any deviation from the NCP approach. IAWC insists that each classification benefits from having a diverse system and therefore should share proportionately based on their non coincident demands. In Staff's view, IAWC's argument confuses the issue. Staff claims the focus of a cost study should not be on who should share in system benefits, but rather on who is responsible for system costs. Staff maintains that the plant is designed to serve the collective peak demand of rate classes. If one class has significant demand at the time of system peak, then Staff asserts it is an important contributor to the cost of that plant. If another class has the same non-coincident peak demand, but uses water mainly when other classes do not, Staff says it makes a correspondingly smaller contribution to that plant's cost. Staff contends that it defies basic cost principles to give equal weight to the peak demands of these two classes in allocating the cost of this plant. (Staff Initial Brief at 70)

Staff says IAWC also claims that a CP approach would be much more subjective than estimating non-coincident demands. It contends that for non coincident demands, one can study the pattern of usage for each class based on actual billing records and system delivery over the course of several months of data. However, for coincident demands, one would have to estimate what each class' usage was on a specific day. Staff says IAWC goes on to argue that it would be especially difficult if the peak day occurred on a weekend, when a portion of the non-residential demand may not have any consumption at all. (Staff Initial Brief at 70-71)

Staff argues that CP demands have been used to develop reasonable cost allocations for many decades by both electric and gas utilities in Illinois. It is not clear to Staff why the water industry should be considered so unique that different rules must apply to the determination of peak demands and the allocation of costs. (Staff Initial Brief at 71)

Under Cost of Service, Staff next discusses, and opposes, IAWC's proposal to use a minimum system approach in the development of customer charges. (Staff Initial Brief at 71) Because IAWC addressed this issue under Rate Design and the summary of IAWC's position is contained in the Rate Design section of this order, the Staff position will also be summarized in the Rate Design section of the order rather than the current section.

Staff next discusses "Class Revenue Allocation and Rate Design." (Staff Initial Brief at 73) In Staff's view, the problems with the Company's proposed maximum day and maximum hour demand factors are of sufficient magnitude to undermine the accuracy of the Company's cost study results. Thus, in the absence of an accurate cost of service study, Staff believes the most reasonable approach is to allocate any revenue change among rate classes on an equal percentage, across the board basis. Staff says that approach recognizes that no reasonable basis has been established for increasing revenues for any individual class more or less than other rate classes in each of the IAWC's divisions. Staff recommends that the impact of any rate changes be equalized for the various rate classes through an across-the-board, equal percent change for class revenue allocations. (Staff Initial Brief at 73)

As far as rate design is concerned, Staff suggests the specific proposals presented by each party should be evaluated on its individual merits. According to Staff, those proposals are not necessarily tied to the specific outcome of the Company's cost of service studies filed in this case but rather reflect more general approaches to reflecting costs in the design of rates. Staff says the process could still benefit from consideration of each of these proposals even with the deficiencies in IAWC's cost of service studies. (Staff Initial Brief at 73)

3. IIWC's Position

While IIWC generally agrees with the cost classifications and allocations contained in the Company's cost of service study, it disagrees with the allocation of purchased power costs. In its study, the Company does not differentiate between the purchased power cost it incurs on the basis of its average daily usage and the purchased power cost incurred on the basis of its peaking requirements. (IIWC Initial Brief at 41-42)

IIWC asserts that the variation in purchased power costs is based in part on customer peak demands for water and should be allocated accordingly. IIWC asserts that the Company's costs for power vary between winter and summer. IIWC claims that because the Company uses more power in the summer to meet its peak day and peak hour water demands, its cost of power in the summer and winter differ, but it does not vary exclusively by water volumes. IIWC argues that the Company's cost of service study fails to recognize this fact. (IIWC Initial Brief at 42)

IIWC also responds to arguments by IAWC. IAWC argues that IIWC's suggestion that the Company has misallocated the cost of purchased power in its cost of service study, because 80% of the Company's electric supply is acquired on the basis of a fixed price contract and, therefore, there is no seasonal differential in its power supply costs. In response, IIWC believes IAWC's argument is misplaced, because the reality of power cost procurement is that power cost varies during on-peak and off-peak periods. While IAWC may have revised its power procurement strategy to buy all of its power at a stated dollars per megawatt-hour price, IIWC insists that does not change the reality that power cost varies by month, by its on-peak and off-peak electrical load.

IIWC argues that IAWC's electrical loads are driven, at least in part, by its customer demands for water during peak periods and off-peak periods on the Company's system. In order to accurately measure and allocate the cost causation elements of power cost, IIWC believes this expense should follow the system demand and base volume characteristic. In IIWC's view, a portion of power costs should be allocated on base volume and on peak-day and peak-hour demands of its customers. IIWC maintains that allocation Factor 6 is the proper allocation factor. (IIWC Reply Brief at 28-29)

IIWC suggests that if IAWC has initiated a power procurement contract based on a levelized cost per megawatt-hour, the Commission should conduct a review of IAWC's power supply contract and power consumption practices, to investigate whether it is undertaking reasonable efforts to manage its power procurement in an efficient and low-cost manner. IIWC states that a water utility that may have significant variability in power demands for on-peak and off-peak periods may very well pay significantly more power cost on a average price per kilowatt-hour rather than buying power with a price differential for on-peak and off-peak periods, which would encourage a utility to change operations to use more power during a low-cost period and less during high-cost periods. IIWC also suggests that if IAWC is not undertaking such actions, the Commission should open an investigation and explore whether or not the Company is reasonably managing its cost of power. (IIWC Reply Brief at 29-30)

IIWC believes IAWC's argument, that the use of Factor 6 allocates too much power costs to the extra capacity method, is without merit. IIWC repeats that power cost should be allocated in the same manner as pumping equipment. IIWC says operating pumping equipment is the largest power consumption activity the utility conducts. IIWC believes the costs of power and the cost of the pumping equipment are interrelated and should be allocated in the same manner. (IIWC Reply Brief at 30)

IIWC says the AWWA Manual provides that the demand portion of power costs should be allocated to extra capacity to the degree it varies with demand pumping requirements. Given the variation in costs identified above, IIWC recommends that if the Company's cost of service study is used to increase customer rates in this proceeding, Factor 6 be used to allocate purchased power costs. IIWC indicates that this factor is tied to average flow, and peak day and peak hour demand requirements. IIWC claims it gives recognition to the fact that there is a seasonal pricing difference in purchased power costs and the increased purchased power costs associated with peak periods that usually coincide with peak water demands on the Company's system. (IIWC Initial Brief at 42)

IAWC argues that the AWWA Manual actually provides that power costs are allocated principally to extra capacity only to the degree that they vary with pumping requirements. IIWC says the Company implies that under IIWC's method, the total demand charge would be considered extra capacity. IIWC believes IAWC's position is illogical. IIWC states that IAWC's investment in pumping equipment does not vary by month, but IIWC nevertheless argues that this cost should be allocated using Factor 6. This, IIWC state, is a reasonable conclusion, "because the size of the pumps and the pumping operating costs must vary based on system demands and volume because they are allocated partly on volume and partly on demand according to the Company cost of service study ("COSS"), that use Factor 6 which is tied primarily to average day flows and peak day and peak hour demands." (IIWC Reply Brief at 30-31) IIWC insists that power costs have the same characteristics: power demand that is incurred each month based on hourly demands, and energy that ties to base volume and peaking demands. In IIWC's view, it is not appropriate to distinguish pumping equipment from power cost because they are interrelated.

C. Commission Conclusion

As indicated above, IAWC performed a cost of service study, using the Base-Extra Capacity method to functionalize, classify and allocate costs to its customer classes. As discussed later in this order, rates within each class consist of fixed customer charges that vary by meter size, and unit rates that are based on customer usage levels.

The contentious issues surrounding demand factors in the analysis of cost of service for IAWC have been addressed in several Commission proceedings. As explained by Staff, the derivation of demand factors is a critical step in the cost allocation process in order to ensure that each class receives a reasonable share of system costs. In Docket No. 02-0690, IAWC did not present cost of service studies and initially proposed across the board rate increases, while Staff presented cost of service studies that it recommended the Commission rely upon in determining cost responsibility. The Order in Docket No. 02-0690 reveals that the Large Water Consumers ("LWC") complained about the demand factors relied upon by Staff in that case. Specifically, the Order states:

> The LWC complain that Staff relied on demand ratios that were developed more than five years ago in Docket 97-0102 and improperly applied those demand ratios to districts for which they were not originally designed. The LWC assert that demand ratios can differ by district and therefore, Staff's use of demand ratios that are stale and were never based on the districts

> to which Staff applied them resulted in a severe flaw in its cost of service study. (LWC brief at 16-17; LWC BOE at 10)
>
> The LWC assert that Staff has not evaluated whether there have been changes to the customer usage profiles of IAWC customer loads. The LWC claim it is not possible to properly assess the demand characteristics and load characteristics of these customers without some analysis. The LWC complain that Staff applied demand factors developed for the Southern and Peoria Districts to the Southern, Peoria, and Streator Districts combined. (LWC brief at 17, citing Tr. 669)

(Docket No. 02-0690, August 12, 2003, Order at 106)

The Commission ultimately found in part that:

> One criticism of Staff's analysis is that the demand ratios used are based on outdated data. On this point, while the Commission appreciates the concerns of other parties such as the AG and LWC, the Commission observes that no other party presented a COS analysis based on more current data. The alternatives to utilizing Staff's cost of service studies as the basis for setting rates in this proceeding appear to involve the use of cost of service studies prepared several years ago. This alternative does nothing to mitigate any purported problems associated with the demand factors, and may in fact exacerbate them by relying upon additional old data. For the reasons given by Staff, the Commission agrees with Staff that the demand data it utilized is sufficiently reliable for use in allocating costs in this proceeding.
>
> With regard to this issue, as stated above, Staff has recommended that IAWC be required to present updated customer demand factors in the Company's next rate filing. The Commission believes such information will help address the concerns cited by other parties. Accordingly, IAWC is directed to provide updated demand factors for each rate area for which a rate increase is proposed.

(Docket No. 02-0690, August 12, 2003, Order at 119-120)

In Docket No. 07-0507, IAWC did not provide the updated demand factors or cost of service studies. IAWC again recommended increasing rates on an across the board basis with the cost of service studies used in Docket No. 02-0690 as the starting point. Staff presented cost of service studies and recommended that those cost of service studies form the basis for rates established in Docket No. 07-0507.

The Commission Order in Docket No. 07-0507 states in part:

> In determining whether to adopt an across-the-board rate increase or Staff's COSS, the Commission notes that Staff, IAWC, the AG, and LWC

> have made extensive arguments both for and against the two proposals. Generally, the Commission prefers to set rates as close to the cost of service as is reasonably possible and/or appropriate. To do so, the Commission must first have an accurate idea of what the cost of serving each customer class is in each district. In this proceeding, Staff has attempted to provide COSS based on information provided by IAWC. The Commission, however, is troubled by the underlying demand factor component of Staff's COSS. As noted by the AG and LWC, the demand factors for each district are based on the demand factors of the Interurban District. For the reasons discussed by the AG and LWC, the Commission is not convinced that the demand factors for the Interurban District are reasonable proxies for the demand factors in IAWC's remaining districts. Due to IAWC's decision not to provide demand factors for each district, as directed by this Commission in Docket No. 02-0690, the Commission does not have an accurate estimate of the cost of serving each customer class in each district.
>
> IAWC's proposed across-the-board rate increase is based on a COSS used in IAWC's last rate case in 2002. This proposal too is imperfect, primarily in that it does not reflect today's cost of serving customers. Absent a more reliable COSS, however, the Commission finds IAWC's proposal a more appropriate means of setting rates in this proceeding. Adoption of IAWC's proposed across-the-board increase also avoids the need to address most of the deficiencies identified in Staff's COSS.

(Docket No. 07-0507, July 30, 2008, Order at 121)

After IAWC did not, in Docket No. 07-0507, provide the updated demand factors required by the final Order in Docket No. 02-0690, the Commission initiated Docket No. 08-0463 on July 30, 2008 to undertake an investigation of IAWC's demand factors, cost of service and rate design. Subsequent to IAWC's filing the current rate case, Docket No. 09-0319, the Commission, on November 12, 2009 dismissed Docket No. 08-0463.

IAWC's demand factors, cost of service studies and rate design proposals in the instant proceeding are derived directly from the studies it undertook and presented in Docket No. 08-0463. IAWC believes the demand factors it has presented are reasonable, reflect the methodology contained in the AWWA Manual and, were derived in a manner consist with a methodology approved by the Commission in Docket No. 08-0463.

Intervenor IIWC complains, however, that the Company's study in this case is not based on demand factors specifically designed for Rate Zone 1 and Rate Zone 1 with Champaign. While IIWC witness Gorman complains that the updated demand factors do not correspond to the pricing districts used in its cost of service study, IIWC does not appear to take issue with how the demand factors were developed. Instead, IIWC urges the Commission to conclude that Illinois-American does not have an accurate estimate of the cost of serving each customer class in Rate Zone 1 with Champaign. (IIWC Exhibit 1.0 at 73-74)

Staff believes the primary problem is IAWC's use of Chicago Metro maximum month ratios to produce maximum day demand factors for all classes in all districts. Staff asserts that IAWC has failed to demonstrate that the pattern of demands for these Chicago Metro customers accurately reflects the demands of IAWC customers on a statewide basis. Staff believes that Chicago Metro usage is more weather-sensitive than other districts. IAWC defends its demand factors, arguing that its assumptions are reasonable and the demand factors were developed in a manner prescribed by the AWWA Manual.

As the Commission understands it, Staff witness Lazare prefers an across the board rate increase rather than relying on the demand factors presented by IAWC in this proceeding. Given that the Commission rejected the demand factors and cost of service studies recommended in Docket No. 07-0507, the effect of Mr. Lazare's recommendation here would be to rely on the demand factors from Docket No. 02-0690. IIWC's recommendation for across the board increases in the Zone 1 rate area would have the same implication.

Staff witness Rukosuev states in his testimony that he is addressing rate design issues and that he is not addressing IAWC's cost of service studies. (Staff Ex. 5.0 at 2) Additionally, Staff witness Rukosuev and Staff witness Boggs both state in rebuttal that the "recommended class revenue requirements include Mr. Lazare’s recommendation as much as possible, while continuing to balance my rate design objectives." (Staff Ex. 12.0 at 5, Staff Ex. 14.0R at 2) Nevertheless, the Commission's review of Staff's testimony and briefs indicates that Staff's proposed consumption charges appear to implicitly rely upon IAWC's cost of service study.

In this regard, Staff Ex. 12.0 at 6 indicates that Staff's proposed usage charges begin with "the Company's proposed consumption rates in order to generate my new proposed consumption rates." IAWC's proposed rates are based upon IAWC's proposed demand factors and its cost of service study. As such, Staff’s approach to setting usage charge appears to be significantly different than Mr. Lazare's recommendation to increase existing rates on an across the board basis. It appears to the Commission that while Staff witness Lazare recommended that IAWC's demand factors and cost of service study be rejected, the consumption rates recommended by Staff witness Rukosuev are based upon those demand factors and cost of service study. In any event, the recommendation of the only witness objecting to IAWC's method for developing demand factors does not seem to be in accord with the recommendation of a different witness for the same party.

It appears to the Commission that at least some of the concerns raised by Mr. Lazare are relevant in evaluating demand factors. It is not clear, however, whether the implication of his recommendation was fully considered. Implicit in recommendations to increase rates across the board is the belief that the demand factors from Docket No.

02-0690 are superior to those developed by IAWC for this proceeding. As noted above, the demand factors from Docket No. 02-0690 were actually derived in Docket No. 97-0102 and are at least 12 years old. It is not clear whether consideration was given to the possibility that Mr. Lazare's recommendation would result in rates that are further from cost-based rates when compared to rates based upon IAWC's proposed demand factors.

As discussed above, IAWC relies in part on the fact that the Commission approved the methodology for developing demand factors in Docket No. 08-0463. Staff contends that IAWC places too much weight or significance on that Commission approval. While the Commission previously approved the general methodology for developing demand factors, it did not approve the specific method utilized by IAWC's consultant, Black and Veach, to develop its recommended demand factors.

Additionally, Staff suggests that IAWC makes too much of the fact that the method used to develop its proposed demand factors were purportedly developed in compliance with AWWA Manual. It appears to the Commission that the IAWC witness on this matter, Mr. McKinley, is qualified to perform such a study and is familiar with performing a demand factor study that would be consistent with the AWWA Manual. This provides the Commission some assurance that the study was performed in a manner in which such studies are normally undertaken in the water utility industry. This does not, however, suggest an absence of concerns with the IAWC's demand factor study.

As noted above, Mr. Lazare has identified some legitimate areas of concern with IAWC's demand factors. The first issue the Commission must address is whether those areas are sufficient to reject the demand study results to be used as the basis of rates established in this proceeding. On this difficult issue, the Commission believes that all things considered, IAWC's proposed demand factors are sufficiently reliable for use in this proceeding. As previously discussed, the Commission finds it significant that the recommendation of the only witness opposing the methodology underlying the demand factors appears to be inconsistent, in certain relevant respects, with the recommendations of another Staff witness.

Next, the Commission will address IIWC's concerns with the demand factors for rate Zone 1. The Commission will not quibble about whether or not IAWC was required to develop demand factors for Zone 1 or Zone 1 with Champaign. It seems to the Commission that IIWC's concern is that the cost of service studies presented for Zone 1 and Zone 1 with Champaign did not incorporate demand factors that reflected Zone 1 (without Champaign) or Zone 1 with Champaign. Instead, those cost of service studies reflected demand factors for SPSPSB.

IIWC is correct that the cost of service studies do not technically include the "correct" demand factors. As IAWC Exhibit 13.00R2 shows, however, the technically "correct" demand factors vary only immaterially from the demand factors that were used. While IIWC argues that it is impossible to know the impact of including the "correct" demand factors because the cost of service studies were not re-run, the Commission believes IIWC's concerns are misplaced. As previously discussed, an issue the Commission must decide, in establishing rates, is whether such rates are cost-based. The Commission rejects IIWC's implicit assumption that demand factors from Docket No. 02-0690, which were actually developed in Docket No. 97-0102, are superior to the demand factors shown on IAWC Exhibit 13.0R2 at page 4.

Having determined that the demand factors proposed by IAWC are reasonable for purposes of this proceeding, the Commission will address the remaining cost of service issues. It appears IAWC and IIWC generally agree that the base-extra capacity method is appropriate for use in this proceeding. Staff witness Mr. Lazare suggests that IAWC should be required to substitute coincident peak demand for non-coincident peak demand in future cost of service studies. Staff witness Mr. Rukosuev implicitly relies upon IAWC's cost of service study in developing his recommended consumption rates. All things considered, the Commission believes that for purposes of this proceeding, the record supports a finding that IAWC's proposed cost of service studies are reasonable.

IAWC opposes Mr. Lazare's recommendation that it be required to use coincident demand rather than non-coincident demand in future cost of service studies. The Commission notes that cost of service studies it has relied on in numerous water rate cases have utilized non-coincident demand and this seemed to be something of a water utility industry approach. While the Commission understands Mr. Lazare's position, it is reluctant to direct IAWC, or any water utility, to incur the costs associated with a methodology it has never approved. (See, *e.g.*, Central Illinois Light Company d/b/a/ AmerenCILCO, et al. Docket No. 07-0585, et al, September 24, 2008, Order at 280) At this time, the Commission does not adopt Mr. Lazare's recommendation; however, Staff or any other party is free to raise this issue in future proceedings or to present their own cost of service study.

As discussed extensively above, Staff recommends that IAWC be required to perform a direct demand study for use in future cost of service studies, which would entail placing time-sensitive meters on a sample of customers to measure their demands on a real time basis, in order to ensure that each class receives a reasonable share of system costs. IAWC objects to the recommendation, claiming it is too costly, has the potential to create operational difficulties and, may not produce better results than an indirect demand study. While acknowledging at least some of IAWC's concerns, Staff maintains that a direct demand study is required.

While the Commission has already found that IAWC's demand factors, derived from an indirect measurement method, should be used for purposes of setting rates in this proceeding, it has done so because the only alternative would produce a worse result. The Commission finds IAWC cost estimate for a direct demand study, $1.86 million, to be unsubstantiated. The Commission, nevertheless, realizes that if it orders IAWC to perform a direct demand study, it could cost a significant amount of money.

Given the numerous and significant concerns raised about the demand factors developed for this proceeding, and subject to the conditions discussed below, the Commission concludes that IAWC will be required to perform a direct demand study for use in future rate proceedings in Illinois. As explained by Staff, the advantage of direct measurement, if performed correctly, is accuracy, because, among other reasons, the indirect calculations of maximum day and maximum hour demand factors employ judgments about the behavior of customer classes within the maximum hour and maximum day that may or may not conform to reality.

Due to the inherent difficulties associated with undertaking a direct demand study, IAWC is hereby required to perform a preliminary planning study and report the results to the Commission. The preliminary planning study report should explain in detail how IAWC will undertake the required direct demand study including a discussion of the types and locations of meters it intends to install and of the data it intends to collect. It should also explain how IAWC will analyze the data collected, provide cost estimates for each aspect of the direct demand study and, an estimate of when the direct demand study will be completed. IAWC is required to submit the preliminary planning study to the Commission as a compliance filing in this docket within 120 days after the order in this proceeding is entered. IAWC is encouraged to work with Staff and any other interested parties in a manner that would allow them have input into the direct demand study. Additionally, the Commission encourages Staff and any other interest party to work with IAWC to avoid a repeat of what resulted from IAWC's indirect demand study.

Unless otherwise ordered by the Commission, the only means by which IAWC could avoid performing the direct demand study required by this order would be to file a petition, within 60 days after the preliminary study is filed, requesting that the Commission eliminate the requirement. Given the long-running controversy surrounding this issue, the Commission cautions IAWC that unless the preliminary planning study produces findings that clearly indicate otherwise, the Commission will not be inclined to eliminate the requirement for a direct demand study. Additionally, in the absence of a petition filed pursuant to this paragraph, or unless otherwise ordered by the Commission, the Commission will expect IAWC to proceed with the direct demand study in a timely manner.

As the Commission understands it, the only other outstanding cost of service issue is how the cost of purchased power costs should be allocated. IAWC contends that the allocation of purchased power costs using Factor 1 correctly reflects actual power costs. IAWC says it has obtained contract pricing for 80% of its test year electric supply. The new power contracts give IAWC fixed pricing throughout the contract term, rather than seasonal rates as were charged with the previous contracts. According to IAWC, there are no seasonal price differentials for power supply costs.

Intervenor IIWC says the AWWA Manual provides that the demand portion of power costs should be allocated to extra capacity to the degree it varies with demand pumping requirements. Given the variation in costs identified above, IIWC recommends that if the Company's cost of service study is used to increase customer rates in this proceeding, the allocation factor used to allocate the cost of the Company's pumps, Factor 6, be used to allocate purchased power costs. IIWC indicates that this factor is tied to average flow, and peak day and peak hour demand requirements. IIWC claims it gives recognition to the fact that there is a seasonal pricing difference in purchased power costs and the increased purchased power costs associated with peak periods that usually coincide with peak water demands on the Company's system.

IIWC also suggests that if IAWC has initiated a power procurement contract based on a levelized cost per megawatt-hour, the Commission should conduct a review of IAWC's power supply contract and power consumption practices, to investigate whether it is undertaking reasonable efforts to manage its power procurement in an efficient and low-cost manner.

The Commission believes the record is clear that IAWC has entered into a purchased power contract for 80% of its test year electric supply and that the new power contracts give IAWC fixed pricing throughout the contract term, rather than seasonal rates as were charged with the previous contracts. In the Commission's view, IIWC's suggestion to allocate purchased power costs, which are largely fixed for IAWC, using an allocation factor that varies with demand pumping would not be appropriate. The Commission finds that IAWC's proposed allocation factor for purchased power costs more reasonably allocates costs that are largely fixed. The Commission also finds that there are insufficient reasons to undertake an investigation of IAWC's power procurement activities at this time. The Commission does not believe doing so at this time would be an efficient use of the Commission's or IAWC's resources.

VIII. RATE DESIGN

As discussed above, IAWC performed a cost of service study to functionalize, classify and allocate costs to each of its customer classes. Rates within each class are designed to recover class revenues, and consist of fixed customer charges that vary by meter size, unit rates that are based on customer usage levels, and fire protection charges.

A. Overview of IAWC's Proposed Rate Design

IAWC states that its rate design proposal in the present case updates the rate design proposals in Docket No. 08-0463, which has now been dismissed. In its Docket No. 08-0463 Initiating Order ("Initiating Order"), the Commission required the Company to (i) provide updated demand factors for all rate areas in which a rate increase was proposed in Docket No. 07-0507 along with a cost of service study, and (ii) investigate all aspects of rate design for all service areas. (IAWC Initial Brief at 128)

In its direct evidence in Docket No. 08-0463, IAWC says it proposed rates based on the revenue requirements authorized by the Commission in the Docket No. 07-0507 Order. The Company also addressed certain rate design issues raised by the

Commission in the Docket No. 07-0507 Order and made related rate design proposals ("Docket 08-0463 Proposals"). In this case, IAWC indicates it has updated the COSS used in Docket No. 08-0463 to reflect the revenue requirements proposed in this case. IAWC is maintaining the Docket 08-0463 Proposals in this case, but has updated them to reflect the updated COSS. As a result of this update, IAWC is proposing to move the Champaign District to Zone 1, and is also proposing certain rate impact mitigation measures. The Company says it developed four alternative rate design proposals in this case, all of which have been presented to the Commission, and recommends its Alternative 3A as shown on IAWC Ex. 9.09 for approval. (IAWC Initial Brief at 128-129)

IAWC says the Commission ordered it to study aspects of single tariff pricing, including (i) review and analyze customer class usage patterns in each downstate district, and it required the Company to propose a uniform block structure if appropriate, (ii) analyzed common usage rages for the SPSPSB District, and (iii) analyze whether the Sterling District should be included in an STP group with the SPSPSB Districts. The Commission also approved the application of certain uniform fees and charges, and ordered the Company to revise its tariffs to make them more uniform and consistent. (IAWC Initial Brief at 129)

The Company agrees that movement toward STP should be made where appropriate. In this proceeding, IAWC has examined both the consolidation of rate areas and the movement towards uniform customer charges, block structures and usage charges. IAWC says this examination is primarily directed to the "downstate" districts: Southern, Peoria, Streator, and Pontiac, which together form one of IAWC's STP areas. In Docket No. 07-0507, these districts were combined in a rate area with South Beloit and referred to as the SPSPSB District and are now part of "Zone 1." IAWC is also proposing to include Sterling and Champaign in Zone 1. IAWC, however, also reviewed whether the approaches to STP discussed above could be applied to other rate areas outside Zone 1. (IAWC Initial Brief at 129)

IAWC is proposing several steps towards STP, including moving Sterling and Champaign into Zone 1 and implementing uniform customer charges, block structures and usage charges in Zone 1, with the exception of the 5/8 inch meter customer charge. The Company is also proposing to include additional fixed costs in its customer charge for all rate areas through a phase in process. For all rate areas, IAWC is proposing a one-block structure for the residential class, which would replace the present declining block structure for that class. IAWC is also proposing to set cost-based public fire charges for all rate areas except Chicago Metro – Water, and is proposing new sewer rates. IAWC is not proposing the expanded use of non-residential demand charges at this time, and intends to collect demand billing data that would allow implementation of non-residential demand charges, if appropriate, in the future. (IAWC Initial Brief at 130)

B. Resolved Rate Design Issues

IAWC initially proposed to continue with a uniform public fire protection rate assessed on all customers in Chicago Metro. In his direct testimony and in AG Ex.

2.05, AG witness Rubin proposed that IAWC establish public fire rates on a graduating scale fixed to the size of each customer's meter, beginning at 5/8-inch, with a maximum charge assessed 1.5-inch meters and larger. Mr. Rubin argued the public fire charge rate structure should reflect the differences in cost of providing fire protection services for various sized customers. IAWC accepted Mr. Rubin's proposal as reasonable, with the caveat that the final rates to be used would have to be based on the final revenue requirement authorized by the Commission. (IAWC Initial Brief at 131) This issue is uncontested, the Commission finds the proposal of AG and IAWC to be reasonable and it is hereby approved.

An analysis of the public fire costs per customer by municipality for the Chicago Metro area and per hydrant by municipality in all other rate areas was prepared and is presented in IAWC Exhibit 9.10. Present levels of public fire protection charges in Lincoln and Pekin are insufficient to meet the cost of service. The Company is proposing public fire charges in those districts be increased 32.2% and 35.5%, respectively, to move the rates toward cost of service levels. Staff supports this proposal. (IAWC Initial Brief at 131) The Commission finds the proposed rates for public fire service to be reasonable and they are hereby approved.

IAWC has proposed consolidating its Champaign and Sterling Districts with Zone 1. In his testimony, Staff witness Boggs recommended that Champaign and Sterling be included in the Zone 1 Single Tariff Pricing Group as proposed in Alternative 3A of IAWC's cost of service study. Mr. Boggs suggested the move would be a step toward STP, which the Commission has supported in past rate cases. In rebuttal testimony, IAWC agreed with Mr. Boggs' recommendation to include Champaign and Sterling in the Zone 1 Single Tariff Pricing Group. IAWC says no other witness opposed consolidation of Sterling or Champaign with Zone 1. (IAWC Initial Brief at 131-132) The Commission finds this proposal regarding the Champaign and Sterling Districts to be reasonable and it is hereby approved. The appropriate level of customer charges for the combined area is addressed separately below.

The Company originally proposed to include on its Tenth Revised Sheet No. 37, sewer rates for Tinley Park Wholesale and Tinley Park Westbury, and its associated areas. Staff recommends that language and references thereto be removed because the arrangement with those service areas is not regulated by the Commission, and should not therefore be included in tariff sheets regulated and approved by the Commission. IAWC does not oppose Staff's recommendation to remove this tariff language. (IAWC Initial Brief at 132) The Commission finds Staff's recommendation to be appropriate and it is hereby adopted.

IAWC is proposing to move customers in Champaign and Lincoln off of their current bi-monthly billing structure, and switch to monthly billing as part of its continuing effort to move toward STP, and to provide consistency and uniformity among the Company's tariffs. Staff agrees with this assessment and states that the proposed move would be reasonable. Staff further recommended revisions to the Company's tariff Sheet No. 11, Section 15, Terms and Conditions of Billing and Payment, letter C to reflect the change, and that the Company be required to file the related changes to the billing interval in its compliance filing for the Rules and Regulations section of Tariff sheet No. 23. The Company agrees with Staff's recommended revisions. (IAWC Initial Brief at 132-133) The Commission finds IAWC's proposal regarding Champaign and Lincoln, with the revisions recommended by Staff, to be reasonable and they are hereby approved.

The Company is proposing to maintain a declining block structure for its non-residential customers. IAWC says the declining block rate structure offers a mechanism to recover cost differences based on class water use and demand characteristics in a fair and equitable manner. Staff does not oppose IAWC’s proposal to maintain the declining block structure. Non-residential users, who are large water users, usually have favorable cost of service characteristics that justify a declining block structure, and the average cost to serve such customers falls as their usage is more evenly distributed throughout the year. (IAWC Initial Brief at 133) The Commission finds this non-residential rate design proposal to be appropriate and it is hereby approved.

Staff proposes to lower the Company’s proposed non-residential 4th block rates to reduce the rate increase for the 100% customer class billing frequency for the Pekin industrial class. Staff is concerned about the magnitude of increase to the 4th block in percentage (approximately a 50% increase) and dollar amount. While IAWC does not agree with Staff's characterization of these increases for the Pekin industrial class as “rate shock,” or that mitigation is warranted for this class, in the interests of resolving issues in the present rate case, the Company accepts Staff's redesign of Pekin industrial class rates. (IAWC Initial Brief at 133) The Commission finds the agreed rate design for the Pekin industrial class to be reasonable it is hereby adopted.

The AG indicates that the 5/8” customer charge for the Pekin district would be nearly identical to the customer charge in Zone 1 ($13.37 and $13.47, respectively). Based on this similarity, the AG recommends setting Pekin’s 5/8 customer charge to be equal to the proposed customer charge for Zone 1. The Company agrees with this recommendation. (IAWC Initial Brief at 134) The Commission finds that the proposal is reasonable to the extent it would set the 5/8 inch customer charge for the Pekin District at the Zone 1 level. The actual level of customer charges for Zone 1 is addressed below in this order.

Staff agrees with IAWC’s proposed rates for 3” meters in the Lincoln district. However, Staff also recommends that in its next rate case, the Company should set customer charges for Lincoln’s meter sizes 3” and greater be set equal to those in Zone 1 and Pekin, so that a more uniform rate design and movement toward STP could be achieved. While not agreeing outright that Lincoln’s rates should be set as Staff recommends, the Company agrees to review and analyze this issue in the next rate case and, if appropriate, make a recommendation to set Lincoln’s customer charges for meter sizes greater than 3” equal to those in Zone 1 and Pekin. (IAWC Initial Brief at 134) For purposes of establishing rates in this proceeding, the Commission finds the proposed rate design for 3" meters in the Lincoln District reasonable and it is hereby approved.

The Company initially opposed maintenance of the current block rate structure of the University of Illinois ("University"). IIWC argues that the current structure should be left intact, and that the Commission should approve a uniform percent change for all University rate elements to coincide for an increase in revenues. The Company agreed to maintain the current rate block structure, and recommends that the determination of the final usage charge be based on the final revenue requirement and rate design as ordered by the Commission. (IAWC Initial Brief at 134-135) For purposes of setting rates in this proceeding, the Commission finds the agreed-to rate design for the University of Illinois to be reasonable and it is hereby approved.

Initial differences between the Company's residential customer count and IIWC's initial customer count led to divergent projections of residential test year revenue. Upon explanation by IAWC regarding the causes of the different counts, IIWC accepts use of IAWC's actual September 2009 residential customer count. However, the Company continues to support its residential test year revenue projection due to concerns that IIWC's projection was based on incorrect customer allocations. (IAWC Initial Brief at 135) The Commission finds the use of IAWC's actual September 2009 customer count to be reasonable and it is hereby adopted.

Given the Commission's interest in use of non-residential demand charges, the Company reviewed the possibility of their further use. At the present time, the Company is not proposing to implement non-residential demand charges, but is proposing to implement demand metering for certain customers considered appropriate candidates for demand charges, such as wholesale and some large industrial customers. Based on the results of this study, the Company will propose demand charges for those customers where appropriate in its next rate case. IAWC says no witness opposed this proposal. (IAWC Initial Brief at 135) The Commission appreciates this effort of IAWC regarding the establishment of demand charges. The Commission finds the Company's proposed course of action to be appropriate at this time and it is hereby approved.

The Company is proposing a uniform after-hours reconnection rate for all rate areas of $138. IAWC says this amount reflects the average cost of after-hours reconnections, in light of the Commission's emphasis on uniform charges in Docket No. 07-0507. Because of the Commission's emphasis on uniformity and its benefits to customers, Staff agrees that after-hours reconnection charges should be uniformly set at $138. (IAWC Initial Brief at 135-136) The Commission finds the proposed uniform after-hours reconnection rate to be reasonable and hereby approves it.

Upon reviewing its $25 home inspection fee applicable to all rate areas, the Company determined that because no home inspections were requested by customers or conducted by the Company over the past three years, the fee should be eliminated. Staff finds this proposal reasonable and concurs that the fee should be eliminated.

(IAWC Initial Brief at 136) The Commission finds the proposal to eliminate the home inspection fee to be acceptable the proposal is authorized.

The Company has proposed various changes to language of its water tariffs. Because the proposed changes add clarity and consistency across the tariff sheets, IAWC says they are unopposed. (IAWC Initial Brief at 136) The Commission finds the proposed tariff changes discussed in this paragraph to be reasonable and they are hereby approved.

Regarding non-residential usage rates, Staff proposes certain mitigation measures. For the Pekin District, Staff maintains that a likely area of concern is the 100% Customer Class Cumulative Billing Frequency – Industrial. Staff insists this class would experience a significant increase in both percentage and absolute dollar terms under the Company's proposed rates. (Staff Initial Brief at 78)

According to Staff, IAWC responds by arguing that such mitigation is unwarranted because the 100% Customer Class Cumulative Billing Frequency (highest usage) – Industrial represents very few customers with high usage levels. Staff argues that although the Industrial class high usage customers consume a significant amount of water, applying the Company's proposed non-residential rates results in an average of $22,239 increase in a monthly bill, which Staff considers to be significant. In the interest of gradualism, Staff proposes slightly lower rates to the 4th block in order to alleviate the considerable rate shock to high users in the non-residential Pekin industrial class. Staff proposes to shift revenues to other rate classes. The resulting mitigation measures reduced bill impacts for the 100% Customer Class Cumulative Billing Frequency– Industrial from $22,239 to $11,601 per month. (Staff Initial Brief at 78)

According to Staff, in the interest of narrowing the issues in this proceeding, while not agreeing that the increase to the 100% customer class billing frequency for the Pekin industrial class constitutes rate shock, IAWC accepts Staff's proposed redesign of Pekin industrial class rates. (Staff Initial Brief at 79)

Staff says the mitigation measures, together with a lower revenue requirement proposed by Staff, lowers bill impacts for the Pekin Industrial class from approximately 43.80% to 31.30%. (Staff Initial Brief at 90-91)

Staff states that IAWC ultimately withdrew its objections to Staff's proposed mitigation measures for nonresidential usage charges. (Staff Initial Brief at 91)

The Commission finds that the above-referenced mitigation measures for nonresidential usage charges, as proposed by Staff, are reasonable and should be adopted.

C. Customer Charges for 5/8 inch Meters

1. IAWC's Position

IAWC developed and presented a number of alternative rate designs in the present case. IAWC recommends that the Commission adopt IAWC's proposed Alternative 3A, shown on IAWC Exhibit 9.08. IAWC says Alternative 3A includes, among other things, moving additional fixed costs into the customer charge for all rate areas through a gradual phase-in, and movement toward a more uniform customer charge throughout the Company's service areas.

IAWC indicates that in the prior rate case, Docket No. 07-0507, the Commission's order stated that IAWC should consider proposing rates whereby a greater portion of its fixed costs will be recovered through the customer charge for each rate class. Pursuant to that directive, the Company is proposing to include more fixed costs in the customer charge. In determining the amount of additional fixed costs to include in customer charges, IAWC conducted a minimum system analysis and included the results as a component of the customer charge. That analysis involved determining what portion of the distribution system results from connecting additional customers to the system regardless of the level of usage. In other words, the minimum system analysis determined what would be the cost of the distribution system if all that were needed was to connect every customer so that they could receive a basic unit of service (one cubic foot of water). (IAWC Initial Brief at 136-137)

IAWC says its basic customer charge was developed in Alternative 1, which incorporates the result of the revised cost allocations using the demand factors discussed above as well as revised customer charges to reflect the customer charge analysis set forth in each cost allocation study. IAWC's basic customer charge includes all fixed customer-related costs properly recovered in the customer charge. IAWC is also proposing to recover further fixed costs through a minimum system charge. IAWC argues that failure to allocate the full fixed costs requires that those costs be recovered through consumption charges, with disproportionate impacts on high-volume customers. The Company expresses concern that such disproportionate recovery would be inequitable, and supports the inclusion of more fixed costs in the customer charge. (IAWC Initial Brief at 137)

To this end, IAWC proposes to recover through the customer charges various items such as depreciation, return and taxes associated with meters and services as well as an allocable portion of administrative and general expenses, payroll taxes and general plant. IAWC asserts that these factors represent actual costs expended in providing customer service and are therefore properly included in fixed cost recovery through the customer charge. IAWC claims their inclusion is also in keeping with the directives of the AWWA Manual. (IAWC Initial Brief at 137-138)

IAWC states that the range of customer costs among districts for a 5/8-inch meter vary from $14.11 per month to $21.61 per month. IAWC asserts that the aggregated state-wide customer costs would result in an $18.14 per month customer charge for a 5/8-inch meter. Based on this analysis, IAWC proposes movement towards a uniform customer charge as follows: a $16.00 per month charge for Zone 1, including Sterling, and Pekin, a $14.00 per month charge for Champaign, a $13.50 per month charge for Chicago Metro - Water, a $10.50 per month charge for Lincoln and a $10.40 per month charge for South Beloit. (IAWC Initial Brief at 138)

In IAWC's view, movement toward a more uniform customer charge in Zone 1 is equitable because, generally, the costs the Company incurs in providing service are similar regardless of where the customers are located. According to IAWC, purchasing, installing, and reading meters, billing customers, and other customer-related costs generally do not vary significantly within Zone 1. IAWC says Staff agrees with this assessment. Where the proposed customer charge is less than $16.00, IAWC indicates that the proposed charge reflects consideration of the potential size of the increase to customer charges, especially for small volume users, that would have been required to move the customer charge all the way to the $16.00 Zone 1 rate at this time. (IAWC Initial Brief at 138)

According to IAWC, the customer charges, as determined in the Alternative 1 rate design, recover the operation and maintenance expenses and capital costs associated with meters and service lines and the operating costs to read a customer's meter and render and collect a bill. IAWC says these are the costs that are typically recovered in customer charges for water utilities. In accordance with the Commission's directive in Docket No. 07-0507 to consider recovery of more fixed costs in the customer charge, however, IAWC says it undertook an additional analysis to identify additional fixed costs that might properly be included in the customer charge. (IAWC Initial Brief at 138-139)

IAWC indicates that its minimum system analysis resulted is a proposed minimum system charge ("MSC") which IAWC proposes to add to the customer charge. IAWC states that, in essence, the minimum system analysis is the basis for a rate design proposal (not a cost allocation) in response to the Commission's directive that IAWC consider inclusion, in the metered service customer charge, of a greater portion of the fixed cost of service for each rate area. IAWC states that the Commission has approved recovery of 80% of a utility's "fixed delivery service" costs through the customer charge in two recent cases: Nicor (Docket No. 08-0863) and the Ameren Illinois Utilities (Docket Nos. 07-0585 et al (cons.)). This suggests to IAWC that the Commission has a strong interest in rate design that recovers fixed costs through the customer charge. IAWC believes the MSC proposal represents a rate design proposal that accomplishes the result the Commission requested in IAWC's prior case. (IAWC Initial Brief at 139)

IAWC says that in the energy utility industry, a common practice is to determine what portion of the distribution system results from connecting additional customers to the system regardless of the level of usage. This is commonly referred to as a minimum system analysis. According to IAWC, the minimum system analysis looks at the effect of including in the metered service customer charges a fixed cost component related to the minimum system, or the system required to connect customers so that they can receive a basic unit of service. IAWC says a basic unit of service can be considered to be one cubic foot of water per day, which could be delivered on an average day. (IAWC Initial Brief at 139)

For IAWC, the smallest size main with a significant length of pipe is a 2-inch main. In its analysis, IAWC applied the current cost of installing each size main to the footage of mains by size to determine the current cost of the actual distribution system. IAWC then applied the unit cost of the 2-inch main to the entire system and divided this result by the actual current cost. This ratio was 38.3%, representing the portion of the distribution system assigned as the minimum system and allocated to the number of customers. The 38.3% factor was then applied to the revenue requirement associated with mains – operation and maintenance expenses, depreciation and return and taxes. IAWC says the revenue requirement associated with the customer portion of the distribution system was divided by the number of customers and 12 months to produce a monthly minimum system cost of $4.67 per customer. IAWC states that since the $4.67 amount of minimum system cost represents an additional 29.2% increase to the proposed $16.00 customer charge, IAWC proposes recovering the minimum system cost in phased-in steps. In this case, IAWC proposes for the first step increase to the customer charge to be $1.75 per month. (IAWC Initial Brief at 139-140; Reply Brief at 95)

According to IAWC, AG witness Mr. Rubin recommends excluding a list of items identified as “overheads” or indirect costs, and excludes these items from recovery in the customer charge. These overheads include executive salaries, advertising, outside services, property tax, and capital stock tax. IAWC asserts that the items the AG seeks to exclude are all cost-causative factors related to providing customer service and billing, and are no less critical to the Company’s ability to provide customer-related services to IAWC’s customers than the direct costs the AG is willing to include. IAWC also claims that Mr. Rubin’s analysis excludes most of the allocable indirect costs that are appropriately allocated as customer costs and also appropriately recovered in customer charges. In IAWC's view, the AG compounds this error by excluding millions of dollars of allocable administrative and general expenses and taxes, such as administrative salaries, other administrative and general supplies and expenses, as well as uncollectible accounts and property taxes. IAWC also argues that the AG's proposal to exclude these items is directly contrary to the Commission order from the previous rate case calling for IAWC to consider including more fixed costs in the customer charge. (IAWC Initial Brief at 140-141)

IAWC claims that all items included in its proposed customer charge are properly considered customer-related costs, and therefore, consistent with the Commission’s directive, can be recovered through the customer charge. IAWC says that while the AG does not consider these items to be “cost based," it has offered no basis on which to conclude that items such as general supplies and administrative salaries are not customer-related (given that, for example, such costs do not vary by the amount of water used). (IAWC Reply Brief at 96, citing AG Initial Brief at 49-50)

IAWC indicates that the AG also opposes IAWC's proposal to add the MSC to the customer charge because in part, the AG incorrectly views it as a cost allocation method rather than simply a rate design approach. IAWC emphasizes that the MSC addition was in response to a Commission directive that required the Company to explore methods to recover additional fixed costs in the customer charge. IAWC believes the proposed MSC is an appropriate and reasonable rate design approach to address the Commission's directive as stated in the prior case. (IAWC Initial Brief at 141)

In its Reply Brief, IAWC states that in their Initial Briefs, neither the AG nor the Municipalities opposed IAWC's proposed inclusion of the MSC in the customer charge. IAWC says the Municipalities also suggest that IAWC's inclusion of costs in the fixed customer charge is unduly burdensome to low-income ratepayers. According to IAWC, no witness in this proceeding identified even one low-income customer who would be unduly burdened by IAWC's proposed customer charge. IAWC also contends that the Municipalities ignore the Commission's directive to consider movement towards inclusion of more costs in the customer charge, as well as IAWC's efforts to otherwise minimize costs. (IAWC Reply Brief at 96-97)

IAWC says Staff and IAWC diverge in their respective treatments of two key issues, namely the calculation of the level of customer charge and the appropriate mitigation on the customer charge increase in Champaign. (IAWC Initial Brief at 141-142; Reply Brief at 94)

IAWC reports that, citing recent Commission decisions, Staff suggests that the Company be limited to recovery of 80% of its fixed customer costs in the customer charge. Staff uses the 80% factor to make various recommendations for customer charges and suggests that the maximum customer charge in any area should be $14.50. IAWC argues that Staff's recommendation has the effect of excluding costs properly included in the customer charge and ignores the allocation for the minimum system component, which makes Staff's calculations incomplete. (IAWC Initial Brief at 142)

It is the Company's position that the orders referenced by Staff (Docket Nos. 08-0863 and 07-0585 et al (cons.)) permitted the utilities in those cases to recover 80% of their "fixed delivery service" costs through the customer charge, and that the fixed delivery services costs include investment in mains that connect all customers as well as other costs that do not vary with volume of service delivered. IAWC argues that the approved recovery in those cases covered more than just the fixed customer costs that Staff uses to calculate the figures for IAWC.

In order to be consistent with these orders, IAWC claims the 80% factor should be applied to all IAWC's fixed customer costs, including the MSC. Applying the MSC to

Staff’s calculations, if the minimum system cost of $4.67 per customer per month were added to the customer costs of $18.14, IAWC says there would be a total of $22.81 of fixed costs per month applicable to the monthly customer charge, 80% of which would equal $18.25. IAWC contends the resulting number is close to the Company’s proposed customer charge of $17.75. (IAWC Initial Brief at 142-143; Reply Brief at 95-96)

Staff recommends that Champaign’s customer charges be set at the same rate as the customer charge in Zone 1 and Sterling, rather than the lower rate proposed by IAWC. Staff suggests that although Champaign’s 5/8-inch meter customers would experience a higher percentage increase in customer charges than other Zone 1 5/8-inch meter customers under Staff's proposal, those customers would benefit from having the costs of capital improvements spread among a much larger customer base, and greater uniformity in the customer charges for all Zone 1 rate areas could be achieved. (IAWC Initial Brief at 143)

IAWC is concerned that Staff's proposed $17.75 customer charge per month for Zone 1 would represent a 58% increase over Champaign’s existing customer charge. For this reason, the Company initially proposed a customer charge for Champaign that is $2.00 less than Zone 1. IAWC states that if the Commission’s order in this case produces a customer charge for Zone 1 that is less than that proposed by the Company, the Company would consider utilizing the same charge in Champaign as is utilized for Zone 1. (IAWC Initial Brief at 143)

For rate design purposes, IAWC is proposing to recover losses from uncollectible accounts on an equal, per customer basis through the customer charge. IAWC says the AG opposes this proposal on the grounds that it would be inequitable for IAWC customers to share the burden of recovering uncollectible accounts equally on a per customer basis. IAWC argues that recovering uncollectible accounts via the customer charge however, allows consumers to share the burden equally and fairly, and is consistent with the allocation of uncollectible expense in the COSS. (IAWC Initial Brief at 148)

According to IAWC, uncollectible accounts are allocated in the COSS on a per-customer basis. With the cost so allocated in the COSS, IAWC insists it is logical that it be recovered in the same manner through an equal customer charge, rather than based on consumption. (IAWC Initial Brief at 148)

IAWC also contends that customer charge recovery of uncollectible expense is consistent with cost causation. IAWC says 91% of uncollectible accounts are allocated to the residential class because the residential class is primarily responsible for the accounts that are written off as uncollectible. IAWC asserts that an analysis of write-offs for the Interurban district in 2008 shows that the residential class’ share of the total write-offs is 91.80%, which is very similar to COSS Factor 13 for residential at 90.98% based on the number of customers. IAWC states that although the AG is correct to point out that recovery of uncollectible expense through the customer charge results in the residential class paying about 90% of uncollectible expense, residential customers are responsible for about 90% of all uncollectible accounts. IAWC claims that contrary to the AG's suggestion, the allocation of this expense to customer charge has nothing to do with a customer's amount of consumption or revenue generated by a customer class. IAWC says that allocating recovery based on consumption would force larger users (principally non-residential customers) to pick up an amount disproportionate to the total amount of uncollectible accounts they are responsible for as a class. (IAWC Initial Brief at 149)

2. The AG's Position

The AG states that IAWC proposed to increase the customer charges in its four water districts from 32.6% to a high of 56.4%, ranging from $17.75 to $15.25 to $12.25 for Lincoln. However, the AG believes these proposed customer charges are not cost-based, and should be reduced to a level that reflects the costs associated with a basic hook up to the system, operations and maintenance expense associated with maintaining the meter and service line and the costs for meter reading, billing and customer service. (AG Initial Brief at 49-50)

The AG argues that IAWC improperly included additional costs associated with overhead and general plant in its customer cost. The AG claims there are 18 cost categories that are not directly related to connecting a customer to the system, reading the customer's meter and sending the customer a bill that IAWC used to justify customer charges as high as $17.75. When inappropriate costs are removed, and assuming that the Commission allows the Company to increases its revenues by the amount requested, the AG claims the customer charges based on an appropriate calculation of customer costs are as follows:

Rate Area	Present 5/8" Customer Charge	Company Proposed Customer Charge	Maximum Customer Charge Based on Cost
Zone 1	$13.39	$17.75	$13.47
Chicago Metro	$ 9.75	$15.25	$12.75
Lincoln	$ 7.91	$12.25	$11.78
Pekin	$12.74	$17.75	$13.37

(AG Initial Brief at 50)

Given how close the Zone 1 customer charge is to the properly determined customer cost, the AG says no change to the Zone 1 customer charge should be approved, and no 5/8" customer charge should exceed the maximum customer charge based on the cost of service. Assuming that the Commission reduces the revenue increase requested by the Company, the AG claims the customer charges will also have to be reduced to reflect the lower cost level. (AG Initial Brief at 50)

According to the AG, the Commission should make it clear that although cost of service principles recommend recovering certain costs in the customer charge, loading more costs than necessary or appropriate in the customer charge creates customer dissatisfaction and disincentives to conserve water. The AG says IAWC and Staff would have the Commission approve very large increases in both the customer charge and the fire protection charge, resulting in fixed charges that diminish the effect of the usage charges to de minimus and discourage people from using water conservatively. (AG Reply Brief at 32)

The AG believes the Commission's interest in increased customer charges in IAWC's last case and in energy cases should not be the sole consideration, and certainly should not override cost of service principles that limit which types of costs should be included in the customer charge. The AG says IAWC is assuming that the Commission has adopted a policy to promote higher and higher customer charges to recover almost all fixed costs. However, the AG argues that not all fixed costs are appropriate for customer charge recovery. AG insists that it is important to limit the customer charge to the recovery of costs that are directly incurred by the utility to enable service to the customer. The AG also contends that overhead expenses that are not directly related to connecting a customer to the system, reading the customer's meter, and sending a bill to the customer may be appropriately included in the revenue requirement, but they should not be recovered through the customer charge. Even if the Commission has expressed an interest in recovery the fixed costs in the customer charge, the AG believes it should only recover fixed customer costs related to connecting the customer to the system in the customer charge. (AG Reply Brief at 32-33)

The AG agrees with Staff that the minimum system analysis does not accurately assess costs because there is simply no reasonable way to divide distribution mains into one component that serves solely to connect customers to the system and a second component that reflects the size of the mains necessary to serve their demands for utility service. The AG also claims the minimum system concept is theoretical only and that the extent that water service could be supplied under a minimum system concept is not known nor has been studied or analyzed. The AG argues that the Commission has properly rejected minimum system cost of service analyses in the past, and should reject it in this case as well. (AG Reply Brief at 33)

The AG says IAWC and Staff both propose substantial increases in residential customer charges while at the same time arguing that declining block rates should be eliminated. The AG indicates the increase in the customer charge is purportedly to allow more recovery of fixed costs in fixed charges. The elimination of a declining block is intended to encourage conservation. Although the AG agrees that a rate design should encourage water conservation, the AG believes high fixed charges (customer charges and fire protection charges) diminish the effect of the usage rate and undermine the conservation effect of a single block rate. (AG Reply Brief at 35)

According to the AG, IAWC's customers, particularly but not exclusively in Chicago Metro, are highly critical of IAWC's rates. The AG asserts that they correctly understand that a rate structure, with high fixed charges, prevents them from controlling their bills and diminishes if not eliminates their incentive to use water carefully. The AG alleges that as they are paying more than their neighbors regardless even if they conserve, there is no incentive to conserve. (AG Reply Brief at 35-36)

The AG claims that Mr. Rubin assigned a reasonable, although not insignificant, portion of fixed costs to the customer charge. The AG believes an assignment of more costs to the customer charge is unnecessary to an accurate matching of costs and rates. According to the AG, basing fixed costs on such a misguided assignment of costs will create a distorted rate design that the public does not understand or accept as just and reasonable. (AG Reply Brief at 36)

3. Staff's Position

Staff reports that IAWC proposes the following 5/8" meter customer charges: $16.00 for Zone 1 (Alton, Cairo, Interurban, Peoria, Streator and Pontiac), including Pekin and Sterling; $14.00 for Champaign; $13.50 for Chicago Metro Water; $10.50 for Lincoln; and $10.40 for South Beloit. (Staff Initial Brief at 85; Reply Brief at 25)

Staff recommends customer charges as follows: $14.50 for Zone 1, including Sterling and Champaign; $14.50 for Pekin; $13.50 for Chicago Metro Water; and $10.50 for South Beloit and Lincoln. In accordance with the Commission's stance on moving toward STP, Staff recommends approval of the Company's proposals to gradually achieve uniform customer charges throughout all IAWC rate areas. According IAWC, to achieve complete customer charge uniformity throughout all IAWC rate areas, the aggregate state-wide customer charge for 5/8" meters would need to be $18.14 per customer. Staff does not recommend complete customer charge uniformity in this rate case because the customer charge in some rate areas would increase by approximately 100%. (Staff Initial Brief at 85-86; Reply Brief at 25)

Staff recommends that Champaign be included in the Zone 1 STP group, and recommends that Champaign customer charges mirror those of all other Zone 1 customers. Staff claims that IAWC Exhibit 9.02 shows that the costs the Company incurs to provide service to customers in Zone 1 are similar throughout the rate areas. Staff believes similar costs to provide water service throughout the rate areas should require similar charges to all customers of those rate areas so the Company could recover no more and no less than those costs. Staff also alleges that although Champaign's 5/8" meter customers would experience a higher percentage increase in customer charges than other Zone 1 5/8" meter customers under Staff's proposal, those customers would benefit from having the costs of capital improvements spread among a much larger customer base. Staff recommends that the customer charge for Champaign 5/8" meter customers should be $14.50. (Staff Initial Brief at 86; Reply Brief at 28-29)

Staff also opined that South Beloit should be excluded from having customer charges that are uniform with the rest of the Zone 1 rate areas because current customer charges for the South Beloit rate area are the lowest in the Company. Staff believes that uniform customer charges for all Zone 1 rate areas at this time would likely result in rate shock for South Beloit customers. Staff expressed concern about the potential for increased billing delinquencies and the accompanying increase in Company collection efforts that would most likely accompany the increased rates. Staff recommends that South Beloit customer charges be set at $10.50 for this rate case and gradually be increased in future rate cases with the goal of an eventual uniform statewide customer charge. (Staff Initial Brief at 86-87)

Staff recommends that the Company recover more of its fixed costs through the customer charge. Staff states that the aggregate state-wide customer charge to recover 100% of the Company's fixed costs is $18.14 per customer according to IAWC. Because the Commission has supported the recovery of fixed costs in the customer charge and has also approved recovery of fixed costs in the customer charge of 80% for certain gas utilities in Illinois, Staff recommends that 80% of the Company's statewide customer costs of $18.14 per month, or $14.50, be the maximum customer charge for 5/8" meter customers in each rate area of IAWC. (Staff Initial Brief at 87; Reply Brief at 25-26)

With regard to IAWC's proposal to use a minimum system analysis in the development of customer charges, Staff believes the proposal is contrary to longstanding Commission policy and should be rejected. IAWC justifies the use of the minimum system by noting Commission Orders in previous cases that allowed utilities to recover 80% of their fixed delivery service costs through the customer charge. Staff says IAWC implies that the minimum system is consistent with these decisions because it considers those fixed delivery services costs to be investment in mains that connect all customers as well as other costs that do not vary with volume of service delivered. (Staff Initial Brief at 71)

Staff insists this argument is deficient. According to Staff, past Commission decisions to recover 80% of fixed costs in the customer charge should not be construed in any way as recognition that a component of main investment serves to connect customers to the system which is the argument of minimum system advocates. Rather, Staff says the Commission decision seeks to recognize that these are sunk costs which will not vary once they are incurred. (Staff Initial Brief at 72)

At the same time, Staff believes the argument for the minimum system remains fundamentally flawed. Staff contends there is simply no reasonable way to divide distribution mains into one component that serves solely to connect customers to the system and a second component that reflects the size of the mains necessary to serve their demands for utility service. Staff argues that there is no identifiable portion of the system that serves solely to connect customers. Staff asserts that the costs expended to connect customers are also spent to meet their demands and, from a cost allocation standpoint meeting those demands is the most important consideration. In Staff's view, the minimum system is unreasonable from a cost perspective standpoint. Staff claims the Commission has consistently rejected all proposals to adopt a minimum distribution system for ratemaking for any utility in Illinois and Staff believes the specific argument by IAWC provides no reasonable basis for the Commission to reverse this longstanding position. (Staff Initial Brief at 72; Reply Brief at 26-28)

In response to IAWC's claim that its proposed minimum system approach is consistent with the Commission's directive in Docket No. 07-0507 to consider recovery of more fixed costs in the customer charge, Staff argues that IAWC decided on its own volition to use the minimum system as a means to identify additional fixed costs that might properly be included in the customer charge. (Staff Reply Brief at 26, citing IAWC Initial Brief at 138-139)

In Staff's view, there are a number of flaws in IAWC's minimum system proposal. Staff asserts that first and foremost is IAWC's assumption that the Commission's interest in recovering more fixed costs through the customer charge signals a willingness to consider adoption of the minimum system approach. Staff insists that the Commission has consistently rejected all proposals to adopt a minimum distribution system for ratemaking for any utility in Illinois. Staff indicates that in its Final Order in an Ameren Illinois Utilities rate proceeding, Docket No. 06-0070 et al (Cons.), the Commission stated that the MDS method fails to properly emphasize the purpose of the distribution system—that being to satisfy a customer's daily demand for electricity. The Commission went on to say it also continues to believe that distinguishing the cost of connecting customers to the distribution system and the cost of serving its demand. (Staff Reply Brief at 27, citing Docket No. 06-0070 et al (Cons.), November 21, 2006, Order at 160-161)

Staff states that the specific customer charge proposed by IAWC should be examined on the evidence presented. In evaluating this charge, however, Staff objects to considering the Company's minimum system argument which Staff insists fails to accurately reflect costs. (Staff Initial Brief at 72; Reply Brief at 28)

4. Homer Glen's Position

Homer Glen objects to IAWC's proposal to shift costs from the usage charge to the customer charge noting that it would cause customers who use lower volumes of water to pay proportionately higher costs. (Homer Glen Initial Brief at 18)

Homer Glen states that the question is not whether such costs should be recovered at all through rates, but rather whether such costs should be recovered in the customer charge. In support of its objection to increasing customer charges, Homer Glen cites the testimony of AG witness Rubin. (Home Glen Initial Brief at 19)

Homer Glen urges the Commission to reject what it describes as Mr. Herbert's "cavalier attitude toward low-income households," especially during these economic conditions. Homer Glen recommends that the Commission accept Mr. Rubin's proposal to exclude inappropriate costs from the customer charge. (Homer Glen Initial Brief at 19)

Homer Glen states that IAWC has proposed consolidating the Champaign district into a new “Zone 1” that would include the current Sterling and South Beloit districts. Under this proposal, the customer charge for residential customers in the Champaign district who receive service with a 5/8 inch meter would be $15.75, which is $2 less than the customer charge for all other 5/8 inch residential customers in the new Zone 1. (Homer Glen Initial Brief at 21)

According to Homer Glen, the lower customer charge for the current Champaign district is designed to mitigate the level of the rate increase to small-volume customers. Homer Glen complains that IAWC would not commit to keeping the differential in the future. (Homer Glen Initial Brief at 21)

Homer Glen argues that in light of the back-to-back double-digit increases imposed on the Champaign district customers, it would be inappropriate to move their customer charge to the level of other Zone 1 customers, now or in the future. Homer Glen asserts that the customer charge proposed by IAWC already has excessive and inappropriate costs. Homer Glen alleges that if the inappropriate items were removed from the customer charge, the charge would decrease not only for the current Champaign district customers but also for all Zone 1 customers. (Homer Glen Initial Brief at 21)

5. Commission Conclusion

Putting aside, for the moment, IAWC's minimum system charge proposal, IAWC proposes movement toward a uniform customer charge as follows: a $16.00 per month charge for Zone 1, including Sterling, and Pekin, a $14.00 per month charge for Champaign, a $13.50 per month charge for Chicago Metro - Water, a $10.50 per month charge for Lincoln and a $10.40 per month charge for South Beloit.

As discussed above, IAWC also performed what it calls a minimum system analysis and proposes that a minimum system charge be added to the customer charge. IAWC's analysis purportedly shows the cost of connecting a customer to its system with the minimum size main is $4.67 per customer. IAWC proposes that the customer charge be increased by $1.75 per month to begin recovery of the minimum system cost through a fixed charge. This proposal is opposed by both Staff and the AG, and is addressed below.

The AG asserts that cost of service supports maximum customer charges of $13.47 for Zone 1, $12.75 for Chicago Metro, $11.78 for Lincoln and, $13.37 for Pekin. For Zone 1, the AG recommends no change in the existing $13.39 monthly customer charge. The AG asserts that IAWC improperly included costs associated with overheads and general plant in its customer costs. IAWC contends that such costs are properly reflected in the customer cost.

Staff recommends customer charges as follows: $14.50 for Zone 1, including Sterling and Champaign; $14.50 for Pekin; $13.50 for Chicago Metro Water; and $10.50 for South Beloit and Lincoln. Because the Commission has supported the recovery of fixed costs in the customer charge and has also approved recovery of fixed costs in the customer charge of 80% for certain gas utilities in Illinois, Staff recommends that 80% of the Company's statewide customer costs of $18.14 per month, or $14.50, be the maximum customer charge for 5/8" meter customers in each rate area of IAWC.

Homer Glen objects to IAWC's proposal to "shift costs" from the usage charge to the customer charge, noting that it would cause customers who use lower volumes of water to pay proportionately higher costs.

As noted above, IAWC proposes to assess a minimum system charge. As an initial matter, the Commission observes that IAWC described its proposal as a rate design proposal and included it in that portion of its briefs. Staff, on the other hand, addressed the proposal as if it were a cost of service issue. Despite IAWC's suggestions, the Commission agrees with Staff that the minimum system issue is essentially a cost of service issue. (See, e.g., Central Illinois Light Company d/b/a AmerenCILCO, et al., Docket No. 07-0585 et al. (Cons.), September 24, 2008, Order at 273-78 and 281-82) In the Commission's view, IAWC's characterization of the minimum system as a rate design issue does not somehow change the underlying nature of the issue or distinguish it from prior cases.

Staff correctly points out that minimum system approaches to cost of service have been presented to the Commission numerous times and have consistently been rejected. In response to the Commission's view that generally, fixed costs should be recovered through fixed charges, IAWC suggests that the minimum system approach represents a rate design proposal to achieve that goal. The Commission, however, is not prepared to fundamentally revise its approach to cost of service by framing the minimum system proposal as a rate design issue.

Thus, while the Commission continues to encourage IAWC to identify fixed costs and to propose reasonable methods for recovering fixed costs through fixed charges rather than through variable usage charges, the Commission does not believe the minimum distribution system as proposed in this proceeding represents an acceptable method for doing so.

Therefore, although the Commission remains open to the possibility that the minimum distribution approach may have merit, it will take a more convincing record than is presented in this proceeding. The Commission finds that the record does not support IAWC's minimum system approach or its proposed minimum system charge, and the proposal is therefore rejected.

With regard to the types of costs properly collected through the customer charge, the AG suggests that costs not directly related to connecting a customer to the system, reading the customer's meter and sending the customer a bill must be excluded from the monthly customer charge. As an initial matter, it appears to the Commission that the AG is making a cost of service argument rather than a rate design argument. Nevertheless, because this is a discrete argument and all parties addressed it under the rate design section of their briefs, the Commission will address it here. The Commission finds no reason to assume that all indirect or overhead costs are variable costs, rather than fixed costs, in nature. Similarly, the Commission believes there is no reason to assume that all customer costs are direct costs rather than a combination of direct and indirect costs.

From a rate design perspective, all other things being equal, the Commission believes it is preferable for fixed costs to be recovered through fixed charges, and for variable costs to be recovered through variable charges, such as usage charges. As IAWC and Staff note, this view has been reflected in recent rate orders including Docket No. 07-0507.

Based on the considerations above, the Commission finds the types of costs included in IAWC's calculations appear to be a more accurate representation of fixed costs to be properly recovered through the customer charge, and the AG's proposed calculations of the fixed customer costs will not be adopted.

With respect to the amount of the customer charge, Staff, as noted above, recommends that 80% of IAWC's statewide customer costs of $18.14 per month, or $14.50, be the maximum customer charge for 5/8" meter customers in each rate area of IAWC. The Commission appreciates that Staff has reviewed and considered the orders in recent rate cases. It appears, however, that Staff may have placed too much significance on the 80% figure appearing therein. In those cases, the Commission was dealing with natural gas utilities that expressed specific concerns about sales and revenue decoupling. Additionally, the 80% fixed cost recovery was adopted as an alternative to the specific revenue decoupling mechanisms proposed by the natural gas utilities.

While the Commission maintains that the 80% fixed cost recovery previously adopted was reasonable, the Commission did not intend for it to somehow become the overriding determinant of customer charges. The Commission believes that in determining appropriate customer charges, the calculated cost of service, the dollar amount of existing customer charges, the dollar amount of proposed customer charges, and the proposed percentage increases are relevant and should not be ignored.

To assist in determining at what level the 5/8 inch meter customer charges should be set, the Commission has developed the table below, which excludes IAWC's minimum system charge rejected above.

Monthly 5/8 inch Meter Customer Charges for Water Service

District	Current Charge	IAWC Calculated Cost	IAWC Base Charge	Staff Proposed	AG Proposed
South Beloit	6.92	19.29	10.40	10.50	13.39
Champaign	11.23	14.11	14.00	14.50	13.39
Sterling	9.09	19.29	16.00	14.50	13.39
Streator	13.39	19.29	16.00	14.50	13.39
Pontiac	13.39	19.29	16.00	14.50	13.39
Southern	13.39	19.29	16.00	14.50	13.39
Pekin	12.74	20.05	16.00	14.50	13.39
Peoria	13.39	19.29	16.00	14.50	13.39
Lincoln	7.91	21.61	10.50	10.50	11.78
Chicago Metro	9.75	17.62	13.50	13.50	12.75

In determining reasonable monthly customer charges, there are numerous considerations, some of which are not directly aligned. Among others, those considerations include uniformity of charges, cost-based rates, as well as dollar and percentage impacts on customer bills. All things considered, the Commission believes that a combination of the customer charges proposed by IAWC, excluding the minimum system charge, and by Staff, will result in the most reasonable 5/8 inch meter customer charges. The table below shows the customer charges the Commission herein approves.

Monthly 5/8 inch Meter Customer Charges

District	Current Charge	Calculated Cost	Approved Customer Charge	Percentage Increase
South Beloit	6.92	19.29	10.50	51.7%
Champaign	11.23	14.11	14.50	29.1%
Sterling	9.09	19.29	14.50	59.5%
Streator	13.39	19.29	16.00	19.5%
Pontiac	13.39	19.29	16.00	19.5%
Southern	13.39	19.29	16.00	19.5%
Pekin	12.74	20.05	16.00	25.6%
Peoria	13.39	19.29	16.00	19.5%
Lincoln	7.91	21.61	10.50	32.7%
Chicago Metro	9.75	17.62	13.50	38.5%

D. Residential Usage Rate Structure - Declining Block Versus Single Block

1. IAWC's Position

IAWC proposes to eliminate the declining block structure for residential customers outside of Chicago Metro, which already has a single block residential rate structure, and replace it with a single block structure. According to IAWC, large usage residential customers are likely using water for discretionary purposes such as watering lawns or other outdoor use. IAWC says this class of customers has a poor load factor and uses water at times of high peak demands when supplies may be near capacity. In IAWC's view, such usage should not be priced at a lower block rate than small users that use water for basic needs.

With a single block structure, all residential usage is priced at the same rate. IAWC reports that although the proposal is supported by Staff, the AG opposes Company's proposal to eliminate the declining block rate for the residential customer class outside of Chicago Metro and recommends switching the Chicago Metro residential class from a single block to a declining block structure. (IAWC Initial Brief at 143-144)

IAWC emphasizes that in the Company's prior rate case (Docket No. 07-0507), the Commission discussed, at length, general considerations regarding movement towards single tariff pricing. IAWC asserts that a single block billing structure is in keeping with those considerations. Further, IAWC claims a single block rate is an increasingly common method of setting rates in the industry, and is acknowledged as such by the AG's principal witness on the issue, Mr. Rubin. (IAWC Initial Brief at 144)

IAWC argues a single usage block structure is particularly appropriate to IAWC's service area in this case, as nearly all (99.3%) of IAWC's residential customers currently fall within the first billing block and so the residential class is essentially functioning as a uniform block structure. Additionally, IAWC claims a one-block rate can be lower than what the first block rate of a declining structure would have to be, and would benefit most users. IAWC believes this uniformity of consumption habits and benefits to consumers confirm that a declining block structure is unnecessary, and, that a single block structure would be preferable. (IAWC Initial Brief at 144-145)

IAWC says the AG's main concern regarding the adoption of a single block structure appears to be that such a structure is unfair to non-residential customers and master-metered residential apartment complexes. IAWC indicates that in Chicago Metro, apartment and condominiums are classified as residential and are already on a one-block structure. IAWC claims any increases experienced by these customers will be no more than that of any single-family residence. IAWC also asserts that master-metered customers in service areas outside Chicago will be unaffected because multi-family dwellings outside of Chicago Metro are typically not classified as residential and will continue on a declining block structure. IAWC claims that the AG has conceded that a single block structure would be appropriate in circumstances where the residential class does not include large apartments and condominium complexes, as IAWC is proposing in the service areas outside Chicago Metro. In IAWC's view, the Commission should approve the proposal to adopt a single block structure for its residential customers outside of Chicago Metro. (IAWC Initial Brief at 145; Reply Brief at 97)

With respect to the AG's suggestion that the Commission require IAWC to eliminate the single block structure presently in place in Chicago Metro, IAWC believes this suggestion should be rejected. IAWC states that the use of a single block rate means that residential users pay the same usage rate per 1000 gallons or CCF of water regardless of their total usage, their per capita usage, or the type of residence they have. IAWC believes a single block residential rate structure in Chicago Metro is reasonable and is consistent with the shift towards single tariff pricing. (IAWC Initial Brief at 145)

IAWC complains that the AG bases its concerns on a single anecdotal customer complaint, by a master meter complex customer, requesting the establishment of a declining block rate structure for Chicago Metro residential customers and that IAWC establish a separate class for multi-family residences. The AG indicates that one "concerned citizen" contacted the AG about a situation with large master metered apartment buildings and combination accounts. IAWC claims that AG witness Mr. Rubin acknowledged, however, that he does not have knowledge of any other specific situation like the one he refers to in his testimony. In IAWC's view, it appears that the AG's proposal to maintain a declining block structure for all customers in all IAWC's service areas and reject IAWC's proposal to adopt a uniform residential usage charge statewide is being driven by the complaints related to one large building complex in Chicago. IAWC argues that this is not an appropriate basis for rejecting IAWC's proposed block structures. (IAWC Initial brief at 146)

According to IAWC, the AG fails to accept that the declining block rate structure allows large usage residential customers to pay more favorable rates for discretionary purposes, such as lawn watering. IAWC states that this class of customers uses water at times of high peak demands when supplies may be near capacity, and IAWC believes the AG has offered no reason why such usage should be charged a lower rate than small volume residential usage. (IAWC Reply Brief at 97)

2. The AG's Position

The AG says IAWC currently has various rate designs in its Districts, and the Company has proposed steps to make the rates in its Districts more consistent. The AG indicates that one of those proposed changes is to create a residential class with a single rate for usage, which is the current rate structure in the Chicago Metro area. The AG believes there are significant problems with this proposal that can be avoided by structuring IAWC's usage blocks to assure that only very large users, who should be less costly to serve due to their large demand, receive the benefit of a declining block. (AG Initial Brief at 50-51)

According to the AG, in all IAWC districts except Chicago Metro, the classification of a customer as residential or commercial is currently irrelevant to the customer's usage rate. The AG says if a large apartment building is master-metered, it pays the same block rate as a commercial business, such as a car wash. The AG claims that precise customer classification has not been necessary in most of Illinois. Under IAWC's proposal to eliminate the declining usage block rate for residential customers but not for commercial customers, the AG asserts that residents of apartment buildings, condominium complexes, and other multi-unit buildings in all areas outside Chicago Metro will be exposed to significant increases.

The AG says it analyzed the bill impact of this change on residential customers using 1.5 inch meters, and showed that the bill increases ranged from 28 to79%. The AG claims that if the declining block were retained in those areas for all customers regardless of classification, no customer's bill would increase by more than 30%. According to the AG, IAWC includes at least 130 customers classified as residential that used 115 CCF per month on average – an amount at least 20 times used by the typical residential customer. In the AG's view, these customers have usage characteristics that are so different from the typical residential customers that it is unreasonable to change their rates to match the rates that apply to single-family residences. (AG Initial Brief at 51)

The AG believes the retention of a residential (or non-class based) declining block usage rate does not promote wasteful use of water. The AG asserts that residential customers simply do not use 30 CCF in a month. The AG claims that of 704,852 residential bills, 99.3% of customers used less than 30 CCF in any given month. The AG contends that IAWC's first block is large enough to eliminate any residential anti-conservation effect. (AG Initial Brief at 51, Reply Brief at 34)

It is the AG's position that elimination of the declining usage block for residential customers outside the Chicago Metro area, while retaining the declining usage block for other customer classes, is bad policy. The AG insists that usage rates should vary with the size of the customer and not be dependent on classification. The AG contends that it is generally less costly for a water utility to sell one million gallons per month to a single customer than to sell that same one million gallons to 200 smaller customers because the cost of distribution tends to be less for very large customers. The AG believes a properly sized declining block usage rate structure will recognize these economies of scale while retaining the conservation message for smaller residential customers who do not use enough water in a given month to trigger the declining block. (AG Initial Brief at 52)

According to the AG, the reasons given by the Staff for supporting IAWC's proposal to eliminate the declining block rate structure for all residential customers (i.e. that the residential class has a poor load factor) ignore the differences between large residential customers and the typical, single-family residential customer. Although Staff and IAWC state that the purpose of eliminating the declining usage block is to discourage excessive residential lawn watering, the AG says they do not address the different usage patterns of residential consumers who live in multi-unit buildings and those that live in single family homes. The AG argues that multi-unit residential customers place different demands on the system and consistently use substantially more water than the ordinary residential customers. The AG contends that often they maintain commercial accounts for common usage, such as lawn watering, so the incentive to conserve that IAWC and Staff use as justification for increasing large residential customers' bills is lost. (AG Reply Brief at 34-35)

The AG says IAWC suggests that because Chicago Metro apartment dwellers already have a single usage block, there is no reason to create a declining block in that area. The AG claims IAWC is asking to change the block structure for the rest of the state to match a block structure in Chicago Metro that creates inequitable bills and that will create substantial confusion over customer classification in the rest of the state. The AG agrees that it is better for IAWC's rate structure to be consistent throughout the state, but rather than impose a detrimental rate structure on large residential customers, the AG claims the more equitable declining block structure in all districts except Chicago Metro should be expanded to Chicago Metro. (AG Reply Brief at 35)

3. Staff's Position

Staff reports that IAWC proposed the one-block rate structure for the residential class in all rate areas including Zone 1, which, according to the Company, better reflects the cost of service for the residential customer class. Under this proposal, a high usage customer would not be subject to lower usage rates under a second block. Staff says the advantage of having a single-block rate for residential usage, the Company believes, is that this would essentially discourage excessive residential lawn irrigation and mitigate summer peak demand. (Staff Initial Brief at 83)

Staff considers a one-block structure for residential customers to be reasonable. According to Staff, a single-block rate structure would better reflect the residential class' cost of service since that class has a poor load factor. In addition, Staff asserts that a single-block structure would provide simplicity, that is, a less complex rate structure that can be easily understood by customers and provide an incentive to conserve water through a usage-based price signal. Staff also says a single-block structure would provide a sense of predictability and more stability in revenues for the Company. Staff recommends that the Company's proposal of a one-block rate structure for the residential customer class be approved. (Staff Initial Brief at 83-84)

4. Homer Glen's Position

Homer Glen states that all of IAWC's rates are composed of a customer charge (which varies by meter size) and a commodity charge. For all districts except Chicago Metro, Homer Glen says the commodity charge declines as consumption rises. Homer

Glen states that the Chicago Metro's residential rates do not contain a declining block component, but all other rate classes do. (Homer Glen Initial Brief at 20)

The Company has proposed eliminating the declining block structure for all residential customers statewide. In addition, the Company proposes a common block structure for all non-residential customers in all areas except Chicago Metro and Lincoln. (Homer Glen Initial Brief 20)

According to Homer Glen, the proposal to eliminate the declining block structure can have a serious impact on some residential customers, such as apartment and condominium complexes who receive service through a master meter. Homer Glen states that IAWC's residential class for the Chicago Metro contains not only single-family homes and apartments but also large apartment and condominium complexes. If the declining block is eliminated, then Homer Glen says those customers will see their bills increase even though their usage has not changed. (Homer Glen Initial Brief at 20)

Homer Glen suggests the master-metered problem may exist outside the Chicago Metro district as well. According to Homer Glen, the AG recommends that the Company's proposal be rejected. Homer Glen says the AG recommends that IAWC conduct an audit to make sure that the Company classifies customers in the same way in all districts and that a separate class be established for master-metered multi-family residential customers and that the new class be billed the same as residential customers. Homer Glen recommends that for the next case, the Company should conduct a cost of service study for the new class to determine the appropriate rate design. (Homer Glen Initial Brief at 20-21)

5. Commission Conclusion

With regard to unit rates based on customer usage, IAWC proposes to eliminate the declining block structure for residential customers outside of Chicago Metro, which already has a single block residential rate structure, and replace it with a single block structure. Staff supports this proposed rate structure.

The AG believes a properly sized declining block usage rate structure will recognize these economies of scale while retaining the conservation message for smaller residential customers who do not use enough water in a given month to trigger the declining block. Rather than eliminating the declining block structure outside of Chicago Metro, the AG would rather see the declining block structure adopted in the Chicago Metro rate area. Homer Glen expresses concerns similar to those raised by the AG.

It appears that the AG's primary concern is that multifamily residential buildings, such as apartment buildings, outside of Chicago Metro, potentially face significant increases if the declining block structure is eliminated. IAWC responds that multifamily dwellings outside of Chicago Metro are typically not classified as residential and will continue to see a declining block rate structure. (IAWC Initial Brief at 145)

The Commission believes declining block structures fail to provide proper price signals to encourage conservation. The Commission does not believe a declining block structure for residential customers in the Chicago Metro area would be in the public interest and the AG's proposal to do so is not adopted. It appears, however, that the AG may have raised a valid concern for some multifamily dwellings outside of Chicago Metro. IAWC's response suggests that there may be some multifamily dwellings outside of Chicago Metro that are, in fact, classified as residential. Thus, IAWC's proposal to eliminate the declining block rate structure for the residential class is approved; however, IAWC is hereby required to allow any multifamily dwelling outside Chicago Metro that is currently classified as residential to be reclassified as nonresidential, at the customer's request.

E. Across the Board Rate Increase Proposal for Consumption Charges

1. IAWC's Position

IAWC believes its COSS is reasonable and in accordance with Illinois practice and prior Commission orders. Staff objects to aspects of the COSS that relate to its concerns with the Capacity Factors Report (demand study). Staff recommends that the Commission reject the Company's proposed revenue requirement allocations based on the COSS in favor of an across the board rate increase. (IAWC Initial Brief at 147)

According to IAWC, Staff's suggestion that the Commission reject setting rates based on cost of service in favor of an across the board rate increase is inconsistent with the Commission's preference for cost-based rates, and is undermined by Staff testimony supporting the COSS methodology. IAWC also asserts that Staff witnesses Mr. Boggs and Mr. Rukosuev, in their rate designs, do not adopt an across the board increase. IAWC insists that the Commission has a preference that rates be set as close as possible to the cost of service for each class. (IAWC Initial Brief at 147; Reply Brief at 98-99)

IIWC also proposes an across the board increase, based on perceived concerns with the Company's Capacity Factors Report and COSS. IAWC claims that IIWC's proposal that the Commission order a uniform percentage increase to all classes in Rate Zone 1 is unsupported. IAWC insists that both the Company's Capacity Factors Report and COSS are reasonable and provide an appropriate basis on which to set rates. IAWC also contends that IIWC's assertion that a uniform change would be more equitable for large users while being generally consistent with the Company's proposals for other classes is entirely unsupported by any evidence. IAWC recommends that the Commission reject proposals for uniform percentage rate changes in favor of the Company's proposals. (IAWC Initial Brief at 147-148; Reply Brief at 99)

2. Staff's Position

In rebuttal testimony, Staff witness Mr. Lazare recommends that the Company's cost of service studies not be used to allocate the revenue requirement among rate classes. Staff states that the most reasonable approach under these circumstances is to allocate any revenue change among rate classes on an equal percentage, across the board basis. (Staff Initial Brief at 93) In its Reply Brief, Staff states that IAWC's failure to address the significant deficiencies in its demand factors means that the results of its cost of service studies remain fundamentally flawed and unsuitable for allocating the revenue requirement among rate classes. Staff states that the Commission should adopt the Staff recommendation to allocate revenue changes among rate classes on an equal percentage, across-the-board basis. (Staff Reply Brief at 25)

In his rebuttal testimony, Staff witness Mr. Rukosuev applied, with some exceptions, an across-the-board (on an equal percentage basis) reduction on the Company's proposed consumption rates in order to generate new Staff proposed consumption charges. IAWC charges that Staff does not propose to reduce on across-the-board were: customer charges (which utilized Staff witness Boggs' recommendation for 5/8" customer meter charges); public and private fire charges (where Staff accepts the Company's proposed charges); and 100% Customer Class Cumulative Billing Frequency Pekin – Industrial, and Chicago Collection & Treatment 2nd block non-residential usage rates. Staff says Mr. Rukosuev incorporated an across-the-board reduction of IAWC's proposed rates as much as possible without conflicting with his own rate design objectives. (Staff Initial Brief at 93-94)

Staff's Initial Brief acknowledges that IAWC's surrebuttal testimony states that Staff's proposed method for developing consumption charges, an across-the-board reduction of IAWC's proposed rates, will not produce an across-the-board increase of existing rates that Staff witness Lazare recommended. (Staff Initial Brief at 94)

3. IIWC's Position

As discussed above in the Cost Service Portion of this Order, IIWC believes the Company's cost of service study in this case suffers from the same deficiency as the study presented by the Company and rejected by the Commission in the last rate case. Under such circumstances, IIWC urges the Commission to reject use the Company's cost of service study in this case for the purpose of determining the revenue allocation and recommend that any rate increase approved be implemented on an equal percentage across-the-board basis. (IIWC Initial Brief at 41)

4. Commission Conclusion

As discussed earlier, Staff witness Lazare recommends that IAWC's cost of service study be rejected and that rates be increased on an across the board basis. IIWC, meanwhile, raises concerns with the demand factors used in IAWC's cost of service for Zone 1, and recommends that Rate Zone 1 with Champaign be increased on an equal percentage as discussed below. IAWC, on the other hand, opposes Staff's proposal to increase rates on an across the board basis. IAWC believes its cost of service studies are reasonable and expresses concern that across the board increases will lead to rates that are not reflective of cost causation.

For the most part, this issue has already been resolved above in this order in the discussion of demand factors and cost of service studies. Mr. Lazare's recommendations on this point have not been adopted. Also, IIWC's concerns, while not entirely without merit, are not significant enough to justify increasing rates on an across the board basis rather than relying on IAWC's cost of service study for Zone 1.

F. Adjustment to Usage Rates to Recover Revenue Requirement

1. Staff's Position

Preliminarily, the Commission notes that Staff's recommendation in this section is somewhat related to, although not in accord with, Staff witness Lazare's position discussed in the section immediately above. In the current section, Staff indicates that if the Commission decides "to adopt a revenue requirement other than that proposed by Staff," then Staff recommends that "each block of Staff's usage charges be adjusted by a uniform percentage to recover the revenue requirement adopted." (Staff Initial Brief at 94-95)

Staff reasons that any deviation from its recommended rates may unintentionally shift revenues to other classes, mitigating the goal of gradualism, as well as mitigating the attempt to minimize rate shock to some classes. Staff believes the recovery of the overall revenue requirement should be evaluated carefully to ensure that it balances consideration of the following rate design factors: cost causation, bill impacts, rate shock, and gradualism. Therefore, Staff believes its proposed rates provide a reasonable balance between cost of service and averting unreasonable bill impacts. (Staff Initial Brief at 94-95; Reply Brief at 33-34)

2. IAWC's Position

According to IAWC, Staff recommends that should any revenue requirement other than Staff's proposal be accepted, the Commission should adjust all rate blocks by a uniform percentage to recover the difference. IAWC asserts that Staff's proposal moves the Company's rate structure farther from cost of service goals, and it should therefore be rejected. The Company proposes that should the Commission choose not to use its revenue requirement, the Commission should nonetheless use the Company's original rate design and scale it back to match the final accepted revenue requirement.

IAWC claims that this proposal will ensure that revenues move towards cost of service goals. IAWC contends that because the Commission intends to generally move towards cost of service for rate design, the Company's proposal aligns with the

Commission's intent and should be accepted. (IAWC Initial Brief at 153-154; Reply Brief at 102)

3. Commission Conclusion

Staff recommends that if the Commission decides to adopt a revenue requirement other than that proposed by Staff, then ''each block of Staff's usage charges be adjusted by a uniform percentage to recover the revenue requirement adopted." (Staff Initial Brief at 94, citing Staff Ex. 12.0R at 19)

In its Initial Brief, IAWC cites the surrebuttal testimony of Mr. Herbert for its recommendation that should the Commission choose not to use IAWC's revenue requirement, the Commission should use the IAWC's original rate design and scale it back to match the final accepted revenue requirement. (IAWC Initial Brief at 154, citing IAWC Ex. 9.00SR (Rev.) at 1-2) A review of that testimony shows that Mr. Herbert stated, "I believe the Company's original rate design should be used and scaled back in order to produce revenues allowed under the Commission's revenue requirement determined in this case."

It is not clear to the Commission what this single sentence means or how, specifically, IAWC believes the rates should be calculated. The Commission's review of Mr. Herbert's direct testimony (IAWC Ex. 9.00), and both his rebuttal testimonies (IAWC Ex. 9.00R1 and IAWC Ex. 900.R2), provided no clarification. Additionally, the Commission's review of the testimony of IAWC's other rate design witness, Mr. Grubb (IAWC Exhibits 5.00 Revised, 5.00 Supp, 5.00R1, 5.002 Revised and, 5.00SR), provided no additional insight as to what IAWC recommends.

IAWC does indicate that Staff's proposal "reflects a typical scale-back approach often used to calculate rates under a lower revenue requirement." (IAWC Ex. 9.0SR at 1) The Commission finds that Staff's proposal for adjusting usage rates is supported by the record, is reasonable and, it is hereby approved.

G. Private Fire Charges

1. IAWC's Position

IAWC indicates that concerns have been raised by Homer Glen witness Chief Schofield about IAWC's fees for maintaining systems necessary for fire protection sprinkler services. IAWC says he questions why there should be a monthly charge for private fire protection.

According to IAWC, the fees associated with these private fire systems represent an allocation of the costs associated with providing fire protection service. IAWC says this includes capital costs for the assets necessary to make the service available, depreciation, taxes, maintenance and administrative costs. IAWC claims that its COSS provides the details as to which costs were allocated (and how) to develop the private fire service rates. IAWC insists that its COSS demonstrates that the private fire charge is appropriate. IAWC argues that because Homer Glen has not identified any specific concern with the level or allocation of private fire charges, the Commission should discard Mr. Schofield's concerns in this matter. (IAWC Initial Brief at 152)

IAWC states that the Municipalities propose for the first time in their Initial Brief, that the Company's recovery of the private fire charge in Chicago Metro be reduced to only cover the cost of service. (IAWC Initial Brief at 101, citing Municipalities Initial Brief at 22-23) Citing the testimony of Staff witness Mr. Rukosuev, IAWC claims the Municipalities' argument is the result of a misconception that the private fire protection charge should be based only on the cost of service. (Id., citing Staff Initial Brief at 85) IAWC also asserts that any reduction of the private fire charge in Chicago Metro would in turn necessitate allocation of that portion of the revenue requirement to other charges or customer classes, possibly creating adverse bill impacts for other customers. IAWC says that it and Staff agree that no reduction to the private fire charge is warranted. (IAWC Reply Brief at 101)

2. Staff's Position

According to Staff, IAWC proposes "increasing private fire rates in all districts, except for Chicago Metro Water, in order to align revenues closer to cost." (Staff Initial Brief at 84) Staff does not take issue with IAWC's proposed Private Fire Protection charges in Zone 1, including Sterling and Champaign.

Staff states that the Company is not proposing an increase for Chicago Metro Water rates because the Company was recovering 138% of cost of service in that water district. Staff believes that the private fire service rates for Chicago Metro should be left unchanged. Staff states that in order to align revenues closer to cost, Staff recommends approving IAWC's proposal to increase private fire protection charges in the areas Pekin and Lincoln, and that such rationale is consistent with Section 9-223(a) of the Act. (Staff Initial Brief at 84)

In its Reply Brief, Staff indicates that Homer Glen, in its Initial Brief, appears to take issue with Staff's proposed private fire protection charges, particularly that the Company would collect more than the cost of providing such services. Staff proposes to leave the private fire protection charge for the Chicago Metro area unchanged. Staff states that although IAWC is currently recovering revenues above the cost of service, there should not be a decrease in rates. Staff remains sympathetic with the Municipalities' concerns; however, Staff claims there are other considerations besides cost of service, such as bill impacts, rate shock and gradualism. Staff believes that Homer Glen ignores these other rate design considerations. Staff says its proposed rates were designed, in part, to avoid creating a greater increase in other charges, thereby actually producing possible adverse bill impacts by shifting revenues across classes. (Staff Reply Brief at 32-33)

3. Homer Glen's Position

Homer Glen states that the Company wants to leave its charge for private fire protection in the Chicago Metro district unchanged even though it is recovering more than the cost of service. Citing Staff, Homer Glen says this request is contrary to the Company's own study that the cost of service is $654,339, and the Company is actually recovering 138% of the cost of service. (Homer Glen Initial Brief at 22-23; Reply Brief at 13)

Homer Glen says there is a potential insurance cost savings when fire sprinklers are installed since it may result in a reduction in property damage insurance, and that this cost savings can be eliminated by the higher-than-appropriate fire protection charge. (Homer Glen Reply Brief at 13-14)

Homer Glen says the high fee also discourages communities to pass ordinances requiring fire sprinkler systems that could save lives and reduce property damage. (Homer Glen Reply Brief at 14)

In Homer Glen's view, labeling the charge as "Fire Protection" on the bill, causes residents to mistakenly believe that the money is going to help support the Homer Township Fire Protection District, when it is not. (Homer Glen Reply Brief at 14)

4. Commission Conclusion

IAWC proposes increasing private fire rates in all districts, except for Chicago Metro Water, in order to align revenues closer to cost. IAWC asserts that the private fire revenues did not sufficiently recover cost of service. Staff does not take issue with IAWC's proposed Private Fire Protection charges in Zone 1, including Sterling and Champaign. IAWC is not proposing an increase for Chicago Metro Water rates because the Company was recovering 138% of cost of service in that water district. Staff believes that the private fire service rates for Chicago Metro should be left unchanged. Homer Glen argues that at a minimum, the private fire charge for Chicago Metro should be reduced to cover only the cost of service.

Except with regard to the Chicago Metro area, the IAWC proposal for private rates appears to be uncontested. With regard to these other districts, the Commission finds IAWC's proposal for fire rates to be reasonable and they are hereby approved.

The cost of providing water service in the Chicago Metro area is generally increasing and the proposal to keep Chicago Metro fire rates at the current level actually represents movement toward rates that are reflective of cost. If the Commission were to adopt Homer Glen's recommendation to reduce the private fire protection charge for Chicago Metro, there would be no choice but to further increase other rates. That is, reducing private fire protection charges at this time would adversely impact other customers. While the Commission understands Homer Glen's position, the record does not support adopting it in this proceeding. Instead, the Commission finds that IAWC's proposal to keep the Chicago Metro private fire protection charges at the current level is in the public interest, is reasonable and, is hereby approved.

H. Public Fire Charges

1. IAWC's Position

Staff initially proposed that the Company be allowed to increase public fire service charges by 19.88% in Zone 1 with Champaign to allow it to recover 100% of its cost of service. The Company agreed with this proposal. IAWC says that in rebuttal Staff proposed that the public fire service recovery be limited to 89% of cost, so as to meet the Staff's proposed revenue requirement. (IAWC Initial Brief at 151)

IAWC urges the Commission to accept Staff's initial proposal to allow the Company to collect 100% of its public fire service costs in Zone 1 with Champaign. IAWC argues that allowing the Company to do so is consistent with Staff's initial proposal, and is consistent with Mr. Rukosuev's acceptance of the Company's proposed public fire rates in other districts. For the sake of consistency and allowing the Company to collect all its reasonable expenses, IAWC recommends that the Commission accept the 19.88% increase in public fire service charges in Zone 1 with Champaign. (IAWC Initial Brief at 151) In its Reply Brief, IAWC says no party opposed IAWC's proposal in their Initial Briefs. (IAWC Reply Brief at 100-101)

2. Staff's Position

Staff indicates that in direct testimony, IAWC recommends an increase in public fire service charges of 32.2% (roughly a 100% recovery of cost of service) and 35.5% (a 77% recovery of cost of service) for the Pekin and Lincoln water districts, respectively, which recover a reasonable level of the cost to provide public fire protection, and an increase of 75.0% (a 67% recovery of cost of service) for the Chicago Metro Water District. According to Staff, IAWC states that the 75.5% increase represents less than half of the updated cost of service for this rate area as shown in IAWC Exhibit 9.01.

Staff accepted the Company's request to increase public fire protection charges in order to align revenues closer to costs associated with providing fire protection service for each district. Staff asserts that to align revenues closer to costs associated with providing fire protection service for each district is consistent with the directive of Section 9-223(a) of the Act, which states, in relevant part, that: "Any fire protection charge imposed shall reflect the costs associated with providing fire protection service for each municipality or fire protection district." (Staff Initial Brief at 74)

In its Reply Brief, Staff reports that its proposed rates began with and were developed to conform to Staff's recommended revenue requirement. Prior to receiving Staff's initial recommended revenue requirement, Mr. Boggs proposed that IAWC increase public fire service charges by 19.88% in Zone 1, including Champaign, to allow it to recover 100% of its cost of service. Staff says that because Mr. Boggs recommended that all customer, usage and Private Fire Service charges should be uniform throughout Zone 1 (except South Beloit) in his proposed rate design model for Zone 1, Mr. Boggs recommended changing only the revenues for Public Fire Services. Staff states that after its initial recommended revenue requirement was presented, Mr. Boggs modified his proposal to allow IAWC to recover only 89% of its cost to provide Public Fire Protection Services. When applying his proposed customer charges, usage rates and Private Fire Service charges to all customers in Zone 1, Mr. Boggs determined that, in order to achieve the Staff recommended revenue requirement, a 23.2% reduction IAWC's proposed Public Fire Service revenue for all applicable customers would be required. (Staff Reply Brief at 29)

Staff disputes IAWC's argument that there is an inconsistency in Mr. Boggs' position. According to Staff, although the specific percentages of recovery have changed, these percentages remain consistent with Staff's evolving revenue requirement for Zone 1. Staff states that subsequent to Mr. Boggs' recommendation for Zone 1 Public Fire Service charges in his rebuttal testimony, Staff again modified its revenue requirement for Zone 1. Due to Staff's most recent recommended revenue requirement, Mr. Boggs again modified his recommendation for Public Fire Service charges in Zone 1. Mr. Boggs is now recommending the Company increase current Public Fire Service revenues by 43.82%, which would allow it to recover in excess of 100% of the cost to provide Public Fire Service. Staff states that Mr. Boggs determined that, in order to achieve the Staff's most recently proposed revenue requirement for Zone 1, a 13.80% increase to IAWC's proposed public fire service revenue for all applicable customers would be required. (Staff Reply Brief at 29-30)

Staff claims that if a new revenue requirement is adopted by the Commission in its Final Order, Staff Exhibit 14.0RC, Schedule 14.1RC can be modified to show the Public Fire Service rates that result from the revenue requirement. Staff suggests that the revenue requirement determined in the Final Order of this case should be input in cell K46 of the "Zone 1" tab in Schedule 14.1RC. Staff asserts the spreadsheet will automatically calculate the resulting final charges for Public Fire Services. According to Staff, changing only the revenues for Public Fire Services will keep all customer, usage and Private Fire Service charges uniform throughout Zone 1 (except South Beloit). (Staff Reply Brief at 30)

3. The AG's Position

The AG argues that in the Chicago Metro area, unlike in IAWC's other service areas, the fire protection surcharge is the same, regardless of the size of the meter or the number of meters on the bill. The AG recommends that the Chicago Metro public fire charge be modified to reflect the same methodology used in other IAWC districts, and says IAWC agreed to this proposal. To the extent that the revenue increase allowed in this docket is less than requested by IAWC, the AG believes the public fire charges should be reduced proportionally. (AG Initial Brief at 52)

4. Commission Conclusion

As the Commission understands it, IAWC is proposing public fire charges for Zone 1 that will allow it to recover the calculated cost of service. It appears that at IAWC's proposed revenue requirement, Staff agreed with the Company's proposed public fire charges for Zone 1. When Staff designed rates to collect Staff's lower proposed revenue requirement, it proposed to lower the public fire charges for Zone 1. It is not clear to the Commission whether the Staff proposal recognizes that when the revenue requirement is reduced, the cost of service also declines. In other words, if one inputs a lower revenue requirement into the cost of service model, the cost of service, including the cost of service for public fire service, would decline.

It is not entirely clear whether there is actually a disagreement between Staff and IAWC. In any event, the Commission concludes that the public fire charges for Zone 1 should be set at 100% of the cost of service, reflecting the revenue requirement approved in this order.

The AG recommends that the Chicago Metro public fire charge be modified to reflect the same methodology used in other IAWC districts, and it appears IAWC agrees to this proposal. The proposed structure would result in fire protection charges that vary by the size of the meter or the number of meters on the bill. The Commission finds that the fire protection rate structure agreed to by IAWC and the AG for the Chicago Metro area to be reasonable and it is hereby approved.

I. Rates for Competitive Industrial and Large Sales for Resale Classes

1. IAWC's Position

According to IAWC, IIWC argues that the Company’s proposed rate increases in Zone 1 for the Competitive Industrial and Large Sales for Resale classes are too low, and that the proposed increase for the Large Other Public Authority class is too high. IAWC claims that the proposed revenue for the Large Other Public Authority classification in Zone 1 is approximately $255,000 less than the amount supported by the COSS. (IAWC Initial Brief at 152)

IIWC’s other class-specific complaints, IAWC states, allege that the rate increases for the Competitive Industrial and Large Sales for Resale classes were lower than could be supported by the COSS. IAWC argues that because these two classes have alternative sources of supply to which they could switch if the Company’s rates rose too high, competitive pressures require the Company to keep the rates at a certain level. IAWC also contends that even with rates lower than could be supported by the COSS, keeping these customer classes on the Company’s system directly benefits other ratepayers through those classes’ contributions to fixed costs, which remaining classes would otherwise bear. (IAWC Initial Brief at 152-153)

IAWC indicates that the contract rates have been approved by the Commission. In order to achieve approval, IAWC says the contract customers and the Company had to demonstrate that a viable alternative supply was available. IAWC states that the contract customers, MEMJAWA in the large sales for resale class and Sauget in the competitive industrial class, both have alternative supplies. According to IAWC, the cost allocation study shows that the variable cost to produce water (power, chemicals, waste disposal) is approximately $0.43 per CCF. IAWC avers that each of the contract customers' rates is far in excess of the variable costs, which means these customers are providing a contribution to fixed costs. In IAWC's view, because the competitive rates recover IAWC's incremental cost of service and provide a contribution to fixed costs, if the competitive customers left IAWC's systems, IAWC's other ratepayers would be deprived of the benefit of this contribution to fixed costs. IAWC believes that IIWC's criticism should therefore be disregarded. (IAWC Initial Brief at 153)

In its Reply Brief, IAWC alleges that IIWC does not address IAWC's explanation in its Initial Brief. (IAWC Reply Brief at 101-102)

2. IIWC's Position

IIWC states that the Company proposed significant variations in the percentage rate increases for the customer classes in the new Rate Zone 1 with Champaign District. IIWC claims that the Company's COSS for Rate Zone 1 with Champaign produces variation and rate increases that are inconsistent with, or not justified, by the COSS. (IIWC Initial Brief at 43)

According to IIWC, there are two rate classes for which the Company proposed relatively small rate increases. The competitive industrial rates would increase by 5.4% compared to the system average increase of 30.8%. The large sales for resale customers would increase by 7.7% compared to the system average increase. IIWC indicates that the COSS study presented by the Company justified increases above the system average increase for these classes. In rebuttal, the Company presented testimony to the effect that customers in these rate classes had competitive alternatives and that keeping rates for these customer classes as low as possible would help retain them on the system because they contribute to the Company's fixed costs, which would otherwise be passed on to its remaining customers.

IIWC contends that the Company has not provided support for its conclusions, and in the absence of such support, the Company's revenue allocation for Rate Zone 1 with Champaign should be rejected and rates should be increased on an equal percentage basis for the customers within that rate zone. IIWC notes that to the extent the Commission accepts the Staff's overall recommendation that the rates for customer classes in each rate zone be increased on an equal percentage basis, IIWC's specific recommendation to increase rates, within Rate Zone 1 with Champaign, on an equal percentage basis, would be moot. (IIWC Initial Brief at 43-44)

3. Commission Conclusion

IIWC expressed concern that IAWC is proposing relatively modest increases of 5.4% for the competitive industrial rate class and 7.7% for the large sales for resale class, compared to the system average increase of 30.8%. IIWC believes IAWC has not adequately supported its assertion that customers in these rate classes have competitive alternatives and that keeping rates for these customer classes as low as possible would help retain them on the system because they contribute toward recovery of IAWC's fixed costs, which would otherwise be passed on to its remaining customers. IIWC believes IAWC's proposed increase for the Large Other Public Authority class is too high.

IIWC recommends that IAWC's proposed revenue allocation for Rate Zone 1 with Champaign be rejected and rates be increased on an equal percentage basis for the customers within that rate zone. IIWC notes that to the extent that the Commission accepts the Staff's overall recommendation that the rates for customer classes in each rate zone be increased on an equal percentage basis, IIWC's specific recommendation to increase rates, within Rate Zone 1 with Champaign, on an equal percentage basis, would be moot.

In response, IAWC argues that because these two classes have alternative sources of supply to which they could switch if the Company's rates rose too high, competitive pressures require the Company to keep the rates at a certain level and that doing so directly benefits the other customer classes. IAWC indicates that the contract rates have been approved by the Commission. In order to achieve approval, IAWC says the contract customers and the Company had to demonstrate that a viable alternative supply was available.

The Commission has reviewed the positions of the parties on this issue. IAWC correctly points out that the Commission has previously approved the contract rates about which IIWC complains. While the Commission understands IIWC's concerns, the Commission has already determined that the contract customers in question have viable water supply alternatives. As a result, the Commission has previously determined that IAWC should retain these customers at essentially, discounted rates. The Commission has found, and continues to believe, that these contract customers, even at discounted rates, make a contribution to recovery of IAWC's fixed costs.

The Commission also finds that accepting IIWC's proposal for rates in Rate Zone 1 with Champaign to be increased on an equal percentage basis would likely lead to increased rates for other customer classes, does not appear to be reflective of cost, and is not in the public interest. That proposal will not be adopted.

J. Multi-unit Residential Building Classification

The AG also recommends that the Company should be required to file with its next case sufficient data to establish apartment and condominium customers as a separate customer class. (AG Ex. 2.0 at 21) The AG points to the size of meters and rates of consumption at certain structures to suggest that customers outside Chicago Metro are likely master-metered multifamily residences.

IAWC asserts that these indicia (meter size and volume of consumption) do not lead to the conclusion that the identified structures are indeed master metered multi-family residences. IAWC has reviewed its records and confirmed that only two multi-family customers outside of Chicago Metro are classified as residential. To address the AG's concern, however, IAWC has agreed to engage in a review of its multi-family residential customers to determine their customer classification and propose, if appropriate, a uniform classification of these customers based on the review's findings. IAWC says such revisions, if any, would be included in the Company's next rate case. (IAWC Initial Brief at 146-147)

The Commission finds that the review proposed by IAWC, in response to the AG witness' recommendation, is reasonable and shall be undertaken.

K. Rider QIP

Homer Glen states that when the new rates in this case go into effect, the QIP rider must be reset to zero since the Act prohibits collecting QIP surcharges on projects that are otherwise reflected in the rate base. According to Homer Glen, the Final Order in this docket must ensure that the excess revenues that IAWC will collect under the new QIP Rider for the Chicago Metro and Champaign districts are deducted from the revenue requirements in this docket. (Homer Glen Initial Brief at 23)

IAWC states that Homer Glen's recommendation was not made in the testimony of any witness in this proceeding. IAWC asserts that it appears to ignore the rules relating to QIP riders: QIP projects, by definition, may only include replacements that were not included in the calculation of the rate base in the utility's last rate case. IAWC contends that projects that are included in the final test year rate base in this proceeding would not, by definition, be QIP projects. IAWC believes that Homer Glen's concern regarding excess revenues is unwarranted. IAWC says Homer Glen appears to be suggesting that IAWC's projection of QIP revenues for 2010 should reflect the possibility of more QIP revenues. According to IAWC, revenues at present rates for the test year do not reflect QIP revenues. IAWC says the revenues from these surcharges were eliminated from the forecast to reflect at present rates only base rates revenues. (IAWC Reply Brief at 109-110)

The Commission has reviewed the positions of the parties on this issue. Homer Glen is concerned about a possible double recovery of costs through this proceeding and through IAWC's proposed Rider QIP in Docket No. 09-0251. The Commission finds that no action is necessary to address Homer Glen's concern in this proceeding. The Commission will address Homer Glen's concern, to the extent necessary in Docket No. 09-0251.

L. Chicago Metro Sewer Rate Increase

1. IAWC's Position

IAWC's proposed rate design for Chicago Metro - Wastewater relied upon the results of the cost of service allocation presented in IAWC Exhibit 9.01. According to IAWC, the cost allocation shows the cost of service attributable to Collection Only customers, Collection and Treatment customers, and Treatment Only customers. IAWC says the cost allocation results show that under the allowed rates in the last case, the Collection Only customers are contributing revenues in excess of their costs and the Collection and Treatment and Treatment Only customers are contributing revenues far less than their costs. (IAWC Initial Brief at 149)

IAWC's states that its proposed rate design begins to realign the revenues with the cost of service and is presented in IAWC Exhibit 9.05 – CMWW. For Collection Only customers, IAWC's proposed rates were left unchanged from existing rates, which consists of a fixed charge and a single block consumption charge. IAWC's proposed residential fixed charge for Collection Only customers includes an allowance of 1.33 CCF or 1,000 gallons. For Collection and Treatment customers, IAWC's proposed rates begin to move toward the cost for providing such service and also include a fixed charge, a single-block consumption charge for residential and a two-block consumption charge for non-residential. IAWC says its residential fixed charge also includes an allowance of 1.33 CCF or 1,000 gallons. (IAWC Initial Brief at 150)

Staff witness Mr. Rukosuev contends in his rebuttal testimony that the Company’s proposed rates for certain sewer customers would result in rate shock. The Company says it is currently collecting only 39.0% of its cost of service for Collection and Treatment in the Chicago Metro Sewer rate district. IAWC indicates that Staff, however, specifically proposes amending the 2nd block non-residential usage rates for this rate area. IAWC believes Staff is incorrect in suggesting that the Company’s rates would result in rate shock, and that there is no reason to adjust the Company’s proposed rate increases. (IAWC Initial Brief at 150)

The Company asserts that its proposal for rate increases to the Chicago Metro Sewer Rate Area are intended to further cost-of-service goals, and should be accepted by the Commission. The Company’s rate design for this area is specifically designed to link the residential consumption rate with the first block rate for the commercial class and the customer charges for commercial and residential customers. IAWC says this proposed structure would result in the same bill for residential and commercial customers consuming less than 20,000 gallons per month. IAWC argues that because Staff's proposed adjustment moves away from this goal, it is not cost-based. (IAWC Initial Brief at 150-151; Reply Brief at 100)

AG witness Mr. Rubin recommends that wastewater treatment rates increase by no more than 50%. According to IAWC, limiting the increase to 50% would not allow IAWC to recover its costs, or would simply require shifting the costs elsewhere. IAWC claims the AG overestimates the magnitude of rates likely to be incurred by the average IAWC wastewater treatment customer. Rather than the $70.00 per month for 7 CCF of service suggested by the AG, IAWC claims the actual figure is $63.50 under the proposed rates. IAWC argues that because this limitation is arbitrary and would not allow the Company to move towards achieving the Commission's goals of matching revenues with costs in each district, the AG's proposal should be rejected. (IAWC Initial Brief at 151; Reply Brief at 100)

IAWC also responds to the recommendation of the AG's witness, summarized below, that IAWC be ordered to conduct an independent study, at IAWC's expense, of its wastewater treatment operations to determine whether it is in the public interest to withdraw IAWC's certificate to provide wastewater treatment services. IAWC opposes this suggestion, as indicated in its Initial Brief and in its Reply Brief at pages 106-109. Among other things, IAWC asserts that wastewater treatment is very capital-intensive, and that its treatment options are subject to comprehensive review and approval on many levels, including by the Chicago Metropolitan Agency on Planning ("CMAP") and the Illinois Environmental Protection Agency ("IEPA"), prior to any major projects being undertaken.

IAWC also says Illinois law has established a variety of statutory options by which such municipalities may acquire, construct or operate sewer utility systems, each with its own specific set of provisions and requirements, and that it is outside the scope of the Commission's jurisdiction to require a study to establish a mechanism for this purpose other than that prescribed by statute. (IAWC Reply Brief at 108-109)

2. Staff's Position

Staff accepted the Company's rates design proposal for the Chicago Metro Sewer District which included a one-block rate structure for residential customers and maintaining a declining two-block rate structure for non-residential customers. Staff states that in order to align revenues closer to costs, an increase in sewer rates is necessary, and in some cases potentially produces significant increases for high volume users. Staff says the effect of the changes varies depending on the level of water use, size of meter, service classification and other factors. Staff suggests that the bill impacts for the Chicago Metro Sewer District constitute rate shock. (Staff Initial Brief at 91-92)

The starting point for Staff's proposed rate design was to apply an across-the-board decrease from the Company's proposed rates. Staff states that while the Company's proposed rate design is intend to better align revenues to cost, Staff insists such a move should not come without an attempt to mitigate rate shock where possible. Therefore, in an effort to mitigate bill impacts, promote gradualism and reduce rate shock, Staff proposes shifting a portion of the revenues to the residential class single-block usage rates in an effort to alleviate significant rate increases to the non-residential (commercial) customer class without an adverse impact on other classes. Specifically, Staff proposes to reduce the Company's proposed 2nd block non-residential usage rates from $3.3361 to $2.6689, and proposes shifting a portion of the reduced revenues to the residential class single block usage rates. (Staff Initial Brief at 92-93; Reply Brief at 30)

In its Reply Brief, Staff states that its proposed rate shock mitigation measures lowers Chicago Collection &Treatment bill impacts for residential, commercial, and multi-unit residential from 56.97%, 128.92%, and 56.26%, to 42.41%, 82.93%, and 42.26% respectively. (Staff Reply Brief at 31) Staff also says that its proposed rates produce average bill impacts for residential, commercial and multi-unit residential customers translate into approximately $20.78, $632.95, and $18.57 average monthly increases, while the rates in IAWC's initial filing produce average monthly increases of approximately $27.46, $1,000.11, and $24.24. (Staff Reply Brief at 32)

Staff also asserts that the proposed rate increases to the Chicago Metro Sewer rate area are intended to further cost of service goals. Staff states that IAWC is currently recovering 39.0% of cost of service, or $4,257,096. Staff says if IAWC's proposed increase is approved by the Commission, IAWC will recover approximately 63.5% of cost of service for Collection and Treatment customers, or $6,960,087. Staff claims that the rates presented in its rebuttal testimony, based on Staff’s revenue requirement, which were approximately 6% lower than rates originally proposed by the Company. Staff argues that consistent with the rate design objectives such as bill impacts, gradualism and rate shock mitigation, Staff managed to alleviate significant rate increases to the non-residential (commercial) customer class without an adverse impact to other classes. As such, Staff continues to disagree with IAWC's argument that no rate shock will result from its proposed increase in rates and that there is no reason to adjust the Company’s proposed rate increases. (Staff Reply Brief at 31)

IAWC argues that Mr. Rukosuev’s rate design moves away from the goal of linking the residential consumption rate with the first block rate for the commercial class and the customer charges for commercial and residential customers. According to the Company, such a structure would result in the same bill for residential and commercial customers consuming less than 20,000 gallons per month. Staff complains that IAWC failed to explain its underlying principle for linking residential and commercial customers under 20,000 gallons. Staff believes that creating merely an aesthetic association between classes is not a practical, nor a compelling, reason to decline a straightforward mitigation measure as proposed by Staff. Staff also notes that its rate design is linked to Staff’s revenue requirement; therefore, its rate design does not radically deviate from the cost of service objectives as the Company claims it does. (Staff Reply Brief at 31-32)

3. The AG's Position

The AG states that IAWC’s cost of service study in this docket revealed that the costs for wastewater treatment are significantly higher than IAWC’s rates. According to the AG, the current wastewater treatment rate for about 5,000 gallons (7 CCF) is currently $28.43. However, to recover half of the cost of service, the AG indicates wastewater treatment rates will have to increase to $51.40, an 80% increase. To recover the entire cost, the AG claims a typical customer's bill just for wastewater treatment would be in excess of $70 per month, to which would be added wastewater collection ($17.52) and water service. (AG Initial Brief at 53)

In the AG's view, this cost is excessive, and consumers cannot be expected to shoulder costs like these, particularly in light of the lower rates charged by other wastewater treatment providers. The AG states that Mount Prospect residents Avis Gibons and Robert Boros pay the equivalent of $20.64 and $16.06 per month to the Metropolitan Water Reclamation District for wastewater treatment. In three IAWC areas, the AG says consumers pay a purchased wastewater treatment charge on their IAWC bills. The AG asserts that residential customers pay a third party for wastewater treatment of $17.23 per month in the Rollins area, as of April 1, 2009; $21.28 in the Valley View area as of April 1, 2009; and $44.85 in the Country Club area as of October 1, 2009. (AG Initial Brief at 53)

The AG reports that IAWC serves fewer than 9,000 treatment and collection customers. In four of the nine areas, the AG indicates it serves fewer than 100 customers, but in Homer Glen it serves 7,323 customers. The AG notes that Homer Glen Trustee Mary Niemiec expressed concern that unreasonably high water and sewer rates will drive builders and homeowners away from Homer Glen, creating a cycle where the remaining captive customers of IAWC will pay even higher rates.

The AG says that the proposed sewer rate is 210% to 518% higher than that of surrounding communities. The AG states that in 2009, Mokena charges $3.60 per 1,000 for collection and treatment, equaling $18.00 for 5,000 gallons of water; New Lenox charges $3.76 per 1,000 for collection and treatment, equaling $18.80 for 5,000 gallons of water. The AG says the sewer charges for Joliet, Manhattan, and Plainfield are $2.04 per CCF (equal to $1.525 per 1,000 gallons). By contrast, the AG says IAWC is requesting a $51.40 residential wastewater treatment charge plus a $17.52 wastewater collection charge, equaling $68.92 – about three times more than charged by other providers. The AG observes that these charges cover half of IAWC's wastewater treatment costs. (AG Initial Brief at 53-54)

Due to the magnitude of the wastewater treatment rate implied by IAWC's cost of service, the AG recommends that wastewater treatment rates increase by no more than 50% -- rather than the 80% proposed by IAWC. (AG Initial Brief at 54)

In its Initial Brief, pages 53-54, the AG notes that its witness recommended IAWC be ordered to conduct an independent study, at IAWC's expense, of its wastewater treatment operations to determine whether it is in the public interest to withdraw IAWC's certificate to provide wastewater treatment services. The AG believes the Commission study should include an assessment of whether there are public or other wastewater treatment operators that can provide the service to IAWC water customers at a more reasonable and comparable cost.

Homer Glen concurs in this recommendation, asserting that all reasonable economic alternatives to providing economic sewer service to Homer Glen's residents should be explored by IAWC and the Commission. (Homer Glen Initial Brief at 23-25) Homer Glen says it is one of the few municipalities where IAWC provides both wastewater collection and treatment, and that the sewer collection and treatment charges are in addition to the rates for water and public fire protection. Homer Glen suggests that it is unreasonable to continue to allow IAWC to continue to provide high-cost sewer collection and treatment services.

4. Commission Conclusion

It is the Commission's understanding that IAWC has proposed Chicago Metro sewer rates that are based upon its cost of service study. Importantly, IAWC has proposed to eliminate the declining block usage rate for residential customers and it appears no party objects to that proposal. In addition to complaining about the overall level of IAWC rates for the Chicago Metro sewer district, the AG recommends that wastewater treatment rates increase by no more than 50%. Staff, for the most part, agrees with IAWC's proposed rate design. In an effort to mitigate bill impacts, promote gradualism and reduce rate shock, Staff proposes shifting a portion of the revenues to the residential class single-block usage rates in an effort to alleviate significant rate increases to the commercial customer class without an adverse impact to other classes.

While the Commission understands the AG's concerns, it does not appear to actually take issue with IAWC's cost of service study for the Chicago Metro sewer district. Additionally, Mr. Rubin indicates he does not know why IAWC's costs are "so high" and does not now why the Company would have such a high capital-related cost. (AG Ex. 2.0 at 24-25) Finally, in the Commission's view, the AG has not provided an adequate explanation of how its proposed 50% rate cap could be implemented or how it would work. The Commission concludes that the rate design proposal of the AG for the Chicago Metro sewer district is not supported by the record and it is not approved.

Staff asserts that its proposed rate design for the Chicago Metro sewer district, when compared to IAWC's, would reduce bill impacts for residential, commercial and multi unit residential from 56.97%, 128.92%, and 56.26%, to 42.41%, 82.93%, and 42.26% respectively. Staff also says that its proposed rates produce average bill impacts for residential, commercial and multi unit residential customers translate into approximately $20.78, $632.95, and $18.57 average monthly increases, while the rates in IAWC's initial filing produce average monthly increases of approximately $27.46, $1,000.11, and $24.24. It appears that the comparisons are based upon different revenue requirements, which reduces their usefulness to some extent. The Commission nevertheless believes that the comparisons provide some context for the IAWC and Staff proposals.

Having reviewed the positions of the parties, the Commission finds that Staff's proposal is more reasonable than IAWC's and should, therefore, be adopted. While the Commission generally favors cost-based rates, the Staff proposal in this instance represents a reasonable deviation from cost, in that it mitigates the potentially large impact on commercial customers without having an unreasonably large impact on other rate classes. To the extent the approved revenue requirement deviates from that proposed by Staff, any change should to rates should be implemented in the same manner as for water rates, via an across the board modification to Staff-proposed usage rates.

As indicated above, the AG witness recommended that IAWC be ordered to conduct an independent study, at IAWC's expense, of its wastewater treatment operations to assess, among other things, whether there are public or other wastewater treatment operators that can provide the service to IAWC water customers at a more reasonable and comparable cost. Municipalities Homer Glen et al. concur in that recommendation. IAWC opposes it.

On this issue, the Commission does not believe there is sufficient information in the record to support a finding requiring an independent audit, the cost and specific scope of which are unknown. It is not clear that any such study or audit would produce a meaningful cost-effective result, or whether the Commission has the authority to implement the results of any such study or audit. The Commission declines to adopt the AG's recommendation at this time.

M. Municipal Rate Comparisons and Other Intervenor Issues

This section of the order primarily addresses concerns about the level of IAWC's water and sewer rates when compared to the rates charged by various municipally-owned water and sewer utilities. This section also addresses certain other issues raised by Intervenors.

Regarding municipal rate comparisons**,** Homer Glen and the AG complain that IAWC currently has water and sewer rates that are far in excess of those charged by surrounding communities. Their positions are discussed below.

1. IAWC's Position

According to IAWC, several parties expressed concern related to the level of IAWC's water and sewer rates when compared to the rates charged by certain municipally-owned water and sewer utilities ("MOUs"), in particular those of Des Plaines, Mt. Prospect, New Lenox and Mokena. The thrust of their argument is that IAWC's rates are unreasonably high because the water or sewer bills of some MOUs reflect rates lower than those of IAWC. (IAWC Initial Brief at 134)

This issue was discussed extensively in IAWC's last rate case, Docket No. 07-0507. The Commission found in that proceeding:

> In the Commission's view, the record demonstrates that there are significant differences between IAWC's cost structure and those of MOUs

> which supports the conclusion that comparisons of IAWC's rates to those of MOUs are not practical for ratemaking purposes. (Docket No. 07-0507 Order at 43-44)

IAWC alleges that the parties have raised the same issues regarding MOU rates that were litigated in the prior case, referring to different representative MOUs as examples. IAWC believes none of the witnesses point to any factor related to the MOUs referenced in this proceeding which would in any way alter the Commission's analysis or conclusions in Docket No. 07-0507. IAWC says it has performed an updated and expanded analysis, drawing on the findings of the Municipal Rate Study and also reviewing the data from the Des Plaines and Mt. Prospect MOUs that was not available in the prior case. IAWC insists that there is no basis to revisit the Commission's conclusions in Docket No. 07-0507, as the existence of the significant differences between IAWC's cost and rate structure and those of MOUs is again confirmed. IAWC maintains that comparisons of IAWC's rates to those of MOUs are not meaningful for ratemaking purposes. (IAWC Initial Brief at 156; Reply Brief at 102-103)

IAWC argues that authority over regulation of rates and rate design of water and sewer utilities differs depending on whether the utility is an investor-owned utility ("IOU") or an MOU. IAWC states that generally, the rates of IOUs are regulated by the state public utility commissions ("PUC"), while the rates for most MOUs are established by their owners (i.e., self-regulated by municipal boards, councils, commissions, water districts, etc.). IAWC says state PUCs have long relied on the cost of service ("COS") standard, also referred to as the revenue requirements method, for establishing just and reasonable utility rates.

According to IAWC, not only does the approach to setting rates vary by type of utility ownership, but the degree or extent of regulation including cost recovery, varies greatly depending on whether the utility is an IOU or an MOU. IAWC contends that the absolute flexibility in establishing rates enjoyed by MOUs allows them to execute rate increases at their discretion, while IAWC must engage in lengthy regulatory processes. IAWC says the Management's Discussion and Analysis section of the Des Plaines 2008 comprehensive Annual Financial Municipal Rate Study ("CAFR") states the following: "Increase/Decrease in City-Approved Rates – while certain tax rates are set by statute, the City Council has significant authority to impose and periodically increase/decrease rates (property taxes, water, sewer, impact fees, building fees, home rule sales tax, prepared food tax, etc.)." (IAWC Initial Brief at 159; Reply Brief at 103)

IAWC asserts that MOUs operate their water and sewer systems on a cash needs basis, but because MOU costs are accounted for in an Enterprise Fund, the MOUs allocate certain costs, including operation and maintenance ("O&M") and administration costs, through inter-departmental charges to the General Fund. Unless municipalities prepare and regularly update indirect cost allocation studies or plans for allocating shared costs for personnel, equipment (e.g., vehicles, computer hardware and software systems) and facilities (e.g., municipal office buildings and parking lots and or garages) incurred by the General Fund to the Enterprise Fund, IAWC claims costs incurred by the water and sewer systems may be understated. (IAWC Initial Brief at 160)

According to IAWC, MOUs also enjoy tax advantages, not available to IOUs. IAWC states that IOUs are responsible for paying taxes to local, state, and federal authorities. These taxes may include property and franchise taxes paid to local authorities; gross receipts, income, capital stock, and franchise taxes paid to state authorities; and income taxes and payroll taxes paid to the federal government. MOUs are not normally subject to taxation by local, state, or federal governments. (IAWC Initial Brief at 160)

IAWC claims that MOUs often include a surcharge for water sold to customers outside the geographic limits of the municipality. IAWC says imposition of non-resident surcharges is a common practice of MOUs. (IAWC Initial Brief at 161)

IAWC states that MOUs utilize plant contribution mechanisms for funding plants, and typically establish water connection and tap fees to generate additional revenues for capital improvement projects, or use grants and/or state low interest loan programs to expand their systems and facilities. For example, IAWC says the Statement of Revenues, Expenses, And Changes in Net Assets for the Water/Sewer Enterprise Funds in the City of Des Plaines 2008 CAFR reflects an intergovernmental amount of $153,853 related to Operating Grants and Contributions. IAWC claims these funds are classified as water/sewer operating revenues and presented as offsetting (subsidizing) operating expenses including capital outlays. In certain cases, IAWC indicates that connection fee revenues are also used by the MOUs to cover ongoing operating costs, thus creating a need for future customers to fund capital projects. (IAWC Initial Brief at 163)

Under applicable regulations IAWC also funds a portion of its plant investment with contributions. However, IAWC claims that the per-customer level of plant cost reflected in rates for the MOUs is substantially below the level of plant cost which IAWC is required to support in rates. IAWC asserts that the ability to collect revenue through fees and other capital funding measures unavailable to IAWC therefore helps MOUs keep rates lower than IAWC. (IAWC Initial Brief at 163)

IAWC contends that MOUs also enjoy direct tax subsidies. For example, IAWC says the DuPage Water Commission ("DWC") is directly subsidized by a district-wide sales tax of 0.25% imposed throughout DuPage County. IAWC also asserts that MOU customers of Des Plaines and Mount Prospect benefit from subsidies related to the purchase of Lake Michigan water. (IAWC Initial Brief at 164)

IAWC alleges that MOUs are presently increasing rates as well. Therefore, IAWC believes the comparison rates referenced by the Municipal Witnesses may soon increase as well, further undermining the rate comparison offered in this case. (IAWC Initial Brief at 165-166)

According to IAWC, Homer Glen witness Mr. Fundich offered various concerns about the present rate case, calling for a reconsideration of MOU and IOU rate comparisons. IAWC alleges that Mr. Fundich has offered no testimony to establish the appropriateness of such comparisons. IAWC argues there has been no change factor related to the MOUs referenced in this proceeding which would affect the Commission's analysis or conclusions reached in Docket No. 07-0507. (IAWC Initial Brief at 166-169; Reply Brief at 104-105)

2. Homer Glen's Position

According to Homer Glen, IAWC currently has water and sewer rates that are far in excess of those charged by surrounding communities. Homer Glen says the proposed increases in this docket would make the differential even higher, further burdening existing ratepayers and putting the municipalities served by IAWC at a disadvantage in attracting new residents and businesses. (Homer Glen Initial Brief at 1)

According to Homer Glen, utility bills are not viewed in a vacuum by ratepayers. Homer Glen says they compare rates with surrounding communities. Homer Glen alleges that when home buyers are looking to purchase, they are becoming aware of the high price for water service in Homer Glen as compared with surrounding communities. In the long run, Homer Glen claims unreasonably high water and sewer rates will drive builders and homeowners away from Homer Glen, creating a cycle where the remaining captive customers of IAWC will pay even higher rates. (Homer Glen Initial Brief at 6)

Homer Glen states that in order for Mokena's residents to pay the same rate as Homer Glen, Mokena would need to increase its rates by 260 percent. For New Lenox, Homer Glen says the increase also would have to be over 200 percent. (Homer Glen Initial Brief at 8)

In Homer Glen's view, what IAWC ignores, however, is the fact that in order for some MOU rates to approach the level charged by IAWC, the municipalities would have to increase their rates by 260 percent. Homer Glen says with IAWC's announced plan of increasing rates every two years, such as the requested 30 percent increase in this case, IAWC's rates will continue to outpace any MOU increase. (Homer Glen Reply Brief at 3)

Homer Glen says the fact that there may be differences between IAWC and MOUs was eliminated by Homer Glen witness Mr. Fundich in his rate comparison analysis. Homer Glen insists that the rate of increase by IAWC far outstrips any increase by MOUs. (Homer Glen Reply Brief at 3-4)

Homer Glen states that IAWC attempts to discredit Mr. Fundrich's conclusion by stating that he did not demonstrate comparability of the respective systems, thus rendering his comparisons meaningless. Homer Glen argues that to the contrary, the Company is the party that has failed to show why its rates are some $117 per month higher than surrounding systems using Lake Michigan water and why the increases have been so staggering. Homer Glen claims that IAWC's Mr. Uffleman, who sponsored the Company's MOU study, when asked whether he studied the operating costs for either the New Lenox or Mokena water utilities, replied, the he has not. Homer Glen asserts that Mr. Uffleman did not even know what percentage IAWC was proposing to increase rates in the Chicago Metro district. (Homer Glen Reply Brief at 4-5)

According to Homer Glen, IAWC erroneously argues that its rates are higher than municipalities because it has extensive regulatory responsibilities related to the drinking water standards (Safe Drinking Water Act (42 U.S.C. §300f et seq.)) and wastewater standards (Clean Water Act (33 U.S.C. §1251 et seq.)). Homer Glen asserts that these are the same standards that must be met by municipally-owned utilities, as IAWC witness Teasley agreed. Homer Glen claims these regulatory requirements are uniform for both IAWC and the surrounding MOUs. Homer Glen says compliance with federally mandated standards should not be more costly for IAWC because it is an IOU. (Homer Glen Reply Brief at 5)

Homer Glen says IAWC then argues that MOUs benefit from the ability to receive contributions in aid of construction from developers who may include the contributions to the MOU in the price of a lot or a home and the purchaser of the lot or home ends up financing the plant contributed by the developer to the MOU as part of their mortgage. According to Homer Glen, this is mere speculation by IAWC and not supported by the record. Homer Glen says it assumes that developers sell homes with line items for each cost of the home such as lumber, concrete, labor, appliances, and the like. Homer Glen asserts that any statements made concerning home builders "marking up" their home prices because of contributions to MOUs is without any factual basis and should be disregarded. (Homer Glen Reply Brief at 5-6)

3. The AG's Position

The AG states that in the Public Forums across the state, consumers expressed frustration that their bills are two to three times higher than in neighboring communities. The AG says they also commented due to the high fixed charges they cannot "conserve their way to a lower bill" and monthly bills that exceed $60 for as little as 2,000 gallons. The AG says lax maintenance practices and poor water quality were also mentioned by more than one participant. (AG Initial Brief at 3-4)

The AG says despite the fact that IAWC only has 308,000 customers and is a relatively small utility by Illinois standards, the public comment page contained 567 comments as of January 7, 2010. By contrast, the AG says the Peoples Gas/North Shore rate case, affecting three to four times as many customers, has attracted only 139 comments. The fact that so many members of the public have taken the time to attend public meetings, and call-in or write a Public Comment about IAWC's increase request, the AG argues, should be taken as a strong signal that IAWC's repeated rate increase requests have become excessive. The AG claims the public is relying on the

Commission more than ever to reign in the excessive spending that underlies this Company's rate request. (AG Initial Brief at 4-5)

In addition to the participation in Public Meetings and on the Commission's Public Comment system, the AG says testimony was submitted by consumers and municipalities addressing IAWC's already excessively high water and sewer prices. The AG states that in the Chicago Metro District, representatives of Mount Prospect, Des Plaines, and Homer Glen submitted testimony describing the large disparities between IAWC rates and the water rates paid by consumers in their towns or neighboring towns who receive water from the municipalities rather than from IAWC. (AG Initial Brief at 6)

The AG states that Mount Prospect Mayor Irvana K. Wilks, who serves on the Northwest Joint Action Water Agency Board, testified that Mount Prospect has both a Village-owned water system and the Illinois American Water system within its boundaries. The AG claims she has the unique perspective and ability to compare the two systems and their impacts to our residents. She expressed concern about the negative impact IAWC's “significant increase in rates” will have on the 22% of its residents and the 16% of its commercial and multi-family buildings that are served by IAW. The AG says she testified that she is concerned about the enormous disparity IAW's proposed increase would create between what residents and businesses pay for Village owned water versus what others pay for IAW water. According to the AG, Mayor Wilks noted that IAWC's proposal would increase the bill of a family that uses 10,000 gallons of water from $46.85 to $67.48, not including purchased water costs. She testified that her Village charges $4.68 per 1,000 gallons with no additional charges.

The AG states that if the proposed rate increase is allowed, IAWC customers would pay 44% more than Village water customers. Mayor Wilks also expressed concern about how the economic downturn has affected Mount Prospect residents, and stated that it would be very irresponsible and inconsiderate in light of the nation's current economic condition” to impose “such a tremendous rate increase, one that is so disparate among residents and businesses in different areas of town. (AG Initial Brief at 6-7)

The AG indicates the City of Des Plaines also submitted testimony addressing the problems created where some residents receive city water at reasonable rates, while other residents pay the substantially higher IAWC rates. The AG notes that City manager Jason Bajor expressed concern about IAWC's significant increase and the increased burden on residents who are already struggling to make ends meet. Mr. Bajor testified that if the rate increase request is approved, residents within Des Plaines that were in IAWC's service area would pay more than triple of what other Des Plaines residents pay for the same water. The AG says Mr. Bajor described the efforts Des Plaines is making to minimize the burden on residents despite its loss of revenue due to the recession and the increased burdens borne by the city as a result of foreclosures, bankruptcies, and job losses among its residents. (AG Initial Brief at 7)

According to the AG, in light of its efforts to keep costs and taxes low, Des Plaines was shocked and disheartened to see that IAWC has hired several new employees and has proposed an aggressive capital improvements program, all during a time of continued record unemployment, and increased foreclosures and bankruptcies. The AG says Mr. Bajor concluded that the Commission should require Illinois American Water to exercise the same restraints on increased spending as the City of Des Plaines and every other City and Village in their service area by cutting unnecessary administrative costs, non-essential capital projects, restricting new hiring, and limiting wage and salary increases. (AG Initial Brief at 8)

The AG says if IAWC is granted the entire rate increase it is requesting, some customers will pay $17.00 per gallon for water and wastewater collection services, while other customers who receive water and wastewater collection and treatment will pay $26.00 per gallon, according to materials prepared by IAWC and used at public meetings in the Chicago Metro area. AG states that IAWC's Chicago Metro rates are already higher than the rates of neighboring communities and already higher than the penny-a-gallon touted by IAWC's promotional materials. The says the rate increase requested in this case, if allowed, will burden consumers who already pay more than is typical in their areas even more. (AG Initial Brief at 10)

The AG states that high water costs have far-reaching consequences that can affect public health, businesses and economic development, and quality of life. The AG says high water charges transfer money and resources out of the community, and burden consumers who may be on fixed incomes, may be facing unemployment, or may otherwise be facing economic challenges. (AG Initial Brief at 10)

According to the AG, IAWC attempts to avoid the effect of consumers' ire at its high rates by arguing that you just can't compare IAWC's rates to local, municipal rates. The AG states that IAWC also incorrectly alleges that parties are attempting to relitigate the issues raised in IAWC's last rate case, where an expert witness for the AG presented a benchmarking study to demonstrate the disparity between IAWC's costs and municipal costs. The AG believes IAWC misses the point of the public participation in this docket. (AG Reply Brief at 36)

In the AG's view, there is no question that IAWC's rates greatly exceed the rates paid for water by residents of communities adjacent to IAWC's service territory. The AG says these are facts. The AG states that every month when residents in the Chicago Metro area open their bills, they know that they are paying an excessive price for the most basic commodity people consume – clean water. The AG contends it is not surprising that in this case these residents were moved to participate in this case and let the Commission know that they find IAWC's rates unreasonable. (AG Reply Brief at 36-37)

The AG says IAWC relies on expert studies and its accumulation of costs to argue that its rates are reasonable, notwithstanding the experience of its Chicago Metro and other customers. According to the AG, the regulatory process is meant to review a public utility's charges, and public understanding and acceptance are key factors that the Commission should consider. The AG states that when reviewing a utility's request to increase rates by 30%; including a request that charges to an affiliate be increased by more than 22%; that it wants to be allowed to pay its attorneys close to $1 million for an 11-month rate case; that it needs to charge consumers more than 10% to compensate its investors when the public is facing declining pension funds and job losses; that it wants consumers to pay more than $400,000 for a "study" of why its affiliate charges are so high; or that it wants to earn a return on a business practices study costing more than $600,000, the Commission should remember the concerns of the consumers who pay for these costs. The AG says these consumers are looking across the street, and are angry that the same water and sewer services are costing their neighbors less than half what they pay IAWC. (AG Reply Brief at 37)

The AG indicates that IAWC expended time and money to support its argument that one cannot compare municipal rates to IAWC rates. The AG states that nevertheless, people do. The AG says when a certificate of public convenience and necessity is issued, it is on the assumption that the private utility can "furnish, provide, and maintain such service instrumentalities, equipment, and facilities as shall promote the safety, health, comfort, and convenience of its patrons, employees, and public and as shall be in all respects adequate, efficient, just, and reasonable." The AG argues that it is becoming apparent that the certificate to IAWC to provide water and sewer service is resulting in rates that the public finds unreasonable and unjust. (AG Reply Brief at 37-38)

In the AG's view, IAWC's arguments that the Commission cannot compare IAWC to local, municipal water providers are ultimately irrelevant. The AG says if IAWC cannot use its unique economies of scale and corporate resources to offer services at rates that are at least comparable to those of other local water systems, it is doing something wrong. The AG suggests IAWC's goal should not be to find arguments to avoid the obvious comparisons that its consumers are making, but to reduce its rates. Rather than spend close to $2 million on studies and efforts to increase rates, AG suggests it should focus on reducing its rates. The AG claims that only when IAWC reduces its rates will consumers and the public stop comparing its rates to their neighbors' rates. (AG Reply Brief at 38)

4. Commission Conclusions

As described above, both the AG and Homer Glen complain that IAWC's rates are higher than surrounding municipally-owned utilities. While IAWC does not dispute the AG's or Homer Glen's assertions, it does argue that direct comparison to MOUs is inappropriate. IAWC attempts to explain why its rates are higher than MOUs and to justify its position that its rates are reasonable.

In Docket No. 07-0507 the Commission found that "Due to the fundamental differences between MOUs and IAWC, it is the opinion of the Commission that a comparison of IAWC's rates and costs to those of MOUs is a very difficult undertaking."

(Order at 44) The Commission believes that conclusion remains true today. While the Commission understands the concerns of the AG and Homer Glen, as a practical matter, the record of this proceeding, combined with the statutory framework within which utility rates are established, provides the Commission with no method whereby these concerns may be fully resolved at this time.

Regarding other Intervenor issues, in its Reply Brief, page 14, Municipalities Homer Glen et al. refer to "Homer Glen issues [that] are not resolved." These "Homer Glen issues" were addressed by IAWC witnesses, but do not appear to have been addressed by Homer Glen in its Initial Brief. In any event, the Commission takes note that these issues remain unresolved as between Homer Glen and IAWC. The Commission will not make any further determinations on them at this time.

In its Initial Brief, pages 26-27, Municipalities Homer Glen et al. state, "The Commission Should Investigate IAWC's Statements that It Provides Water and Wastewater Services 'For Around a Penny a Gallon.'"

In its Reply Brief, pages 110-113, IAWC disagrees. According to IAWC, calculations by the Municipalities combine water and sewer charges; whereas, the language of the communication at issue states that "around a penny a gallon" is what customers pay, respectively, ". . . for a gallon of water delivered to your home, *or* a gallon of wastewater taken away from your home."

In any event, while the heading of IAWC's communication at issue could have been more clearly worded, the Commission does not believe the language cited warrants the initiation of a formal investigation into IAWC's advertising policies at this time.

IV. FINDINGS AND ORDERING PARAGRAPHS

The Commission, having reviewed the entire record herein, is of the opinion and finds that:

(1) IAWC is in the business of furnishing water and sewer service to the public in various areas in the State of Illinois and is a public utility as defined in the Act;

(2) the Commission has jurisdiction of the parties hereto and of the subject matter herein;

(3) the findings and conclusions stated in the prefatory portion of this Order are supported by the evidence of record and are hereby adopted as findings of fact; Appendices A through F attached hereto provide supporting calculations for various conclusions in this Order;

(4) the test year in this proceeding is a future test year consisting of the 12 months ending December 31, 2010; this test year is appropriate for purposes of this proceeding;

(5) for purposes of this proceeding, IAWC's net original cost rate bases are set forth in Appendices A through F;

(6) the Company's December 31, 2008 plant balance reflected on IAWC Schedule B-5 Second Revised, page 3 of 24 is approved for purposes of an original cost determination, subject to any adjustments contained in this order;

(7) a just and reasonable rate of return which IAWC should be allowed an opportunity to earn on its net original cost rate base is 8.05%; this rate of return incorporates a rate of return on common equity of 10.38%;

(8) the rates of return set forth in Finding (7) hereinabove result in operating revenues and net annual operating income as shown in Appendices A through F based on the test year herein approved;

(9) IAWC's rates which are presently in effect for water service and sewer service are insufficient to generate the operating income necessary to permit it the opportunity to earn a fair and reasonable return on net original cost rate base; the currently effective rates should be permanently canceled and annulled;

(10) the rates proposed by IAWC would produce a rate of return in excess of a return that is fair and reasonable; IAWC's Proposed Tariffs should be permanently canceled and annulled;

(11) IAWC should be authorized to place into effect tariff sheets designed to produce annual operating revenues as contained in Appendices A through F, such tariff sheets to be applicable to service furnished on and after their effective date; the terms and conditions in these tariff sheets should be consistent with Finding (12) below;

(12) the cost of service, interclass revenue allocation, rate design, and tariff terms and conditions found appropriate in the prefatory portion of this Order are just and reasonable for purposes of this proceeding and should be adopted; IAWC shall make all filings determined to be appropriate in the prefatory portion of this order above;

(13) the new tariff sheets authorized to be filed by this Order shall reflect an effective date not less than five working days after the date of filing, with the tariff sheets to be corrected within that time period if necessary, except as is otherwise required by Section 9-201(b) of the Act as amended.

IT IS THEREFORE ORDERED by the Illinois Commerce Commission that the Proposed Tariffs proposing a general increase in rates, filed by Illinois-American Water Company on May 29, 2009, are hereby permanently cancelled and annulled.

IT IS FURTHER ORDERED that Illinois-American Water Company is authorized and directed to file new tariff sheets with supporting workpapers in accordance with Findings (11), (12), and (13) of, and other determinations in, this Order, applicable to service furnished on and after the effective date of said tariff sheets.

IT IS FURTHER ORDERED that upon the effective date of the new tariff sheets to be filed pursuant to this Order, the tariff sheets presently in effect for water and sewer service rendered by Illinois-American Water Company which are replaced thereby are hereby permanently canceled and annulled.

IT IS FURTHER ORDERED that Illinois-American Water Company shall make all filings found appropriate in the prefatory portion, and in the findings, of this order.

IT IS FURTHER ORDERED that all petitions for leave to intervene that have not been previously ruled on are granted, and that all other all motions that have not been ruled upon are hereby deemed disposed of in a manner consistent with the ultimate conclusions herein contained.

IT IS FURTHER ORDERED that subject to the provisions of Section 10-113 of the Act and 83 Ill. Adm. Code 200.880, this Order is final; it is not subject to the Administrative Review Law.

By proposed order of the Administrative Law Judge this 22nd day of February, 2010.

Administrative Law Judge